Fiscal Sustainability in South Carolina

Trends and Issues

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By

Ellen W. Saltzman

and

Holley Hewitt Ulbrich

Fiscal Sustainability Report Series

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PREFACE

This report is the fourth in an intermittent series on South Carolina public revenue and spending that have been issued by the Strom Thurmond Institute of Government and Public Affairs. The first three were issued in 1997, 1999, and 2001.

The purpose of this series is to stimulate an ongoing dialogue about an important issue facing the state of South Carolina: the development of a revenue structure and budgetary policies and practices that ensure stable and adequate funding for essential and important state government services in future years.

ABOUT THE AUTHORS

Holley Hewitt Ulbrich, Ph.D. is Alumna Professor Emerita of Economics at Clemson University and a Senior Fellow of the Strom Thurmond Institute. Ellen W. Saltzman, M.A., Economics, is a research associate at the Institute. Both have written extensively about state and local government finances in South Carolina.

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Executive Summary

Fiscal Sustainability in South Carolina: *Trends and Issues*

What is fiscal sustainability?

- Fiscal sustainability refers to a structure of revenue streams, spending obligations, and reserve funds that allow the state to maintain an acceptable level of public services over the long term and through fluctuations in economic activity.
- In order to maintain current public service levels, spending must, at a minimum, keep pace with population growth and inflation. Fiscal sustainability requires that revenue growth also keep pace with population growth and inflation so that real (inflation-adjusted) per capita revenue available to pay for services is unchanged.
- A fiscally sustainable revenue base will raise enough revenue to pay for desired services without relying too heavily on any single revenue source as a share of total revenue and without high tax rates that could discourage locating, working, or shopping in the state.
- If some important government services, such as health care, are experiencing higher rates of inflation, revenue may have to grow faster than population plus inflation in order to sustain the same level of those services. For example, all state agencies (especially school districts) were hard hit during the current year with rapidly rising fuel costs, especially for diesel.

Where has the state been?

- Revenue growth in the General Fund averaged 5 percent a year over the twenty year period since 1987—5.5 percent a year from 1987 to 1997 and 4.5 percent a year from 1997 to 2007, with a sharp drop in 2000 to 2004.
- General fund revenue growth in South Carolina only slightly exceeded population growth plus inflation over the period 1987 to 1997 and fell behind that growth rate over the last ten years.
- Expenditures grew even more slowly than revenue at 4.3 percent a year since 1987. Adjusted for population growth and inflation, state spending rose by an average of 1.1 percent a year from 1987 to 1997, but declined by an average of 2.1 percent a year between 1997 and 2007. Most of that decline was during the state fiscal crisis of 2001 to 2003.
- State spending per capita, adjusted for inflation, is now lower than it was ten years ago, even in key service areas such as elementary and secondary education, higher education, and aid to subdivisions (counties and municipalities).

Where is the state heading? Revenue surplus or revenue shortfall?

- South Carolina General Fund revenue projections for 2013 range from $6.9 billion to $7.1 billion, assuming no shocks to the system or further tax cuts. Revenue projections are driven by assumptions about the rate of personal income growth and the responsiveness of sales and individual income taxes to income growth.
- Projected General Fund expenditures for 2013 range from $7.0 billion to $8.9 billion, depending on assumptions about future spending growth. Spending projections do not

include estimates of the cost of new programs, even in the highest growth projections. Real (inflation-adjusted) spending per capita remains below earlier levels in these projections.

- The lowest spending projection, $7.0 billion in 2013, is based on historic growth trends in appropriations for major budget categories, with the 2009 base year reflecting the October 2008 spending cut and no spending growth projected for 2010. Projected revenue is below this spending projection for every year except 2013.
- If the state chooses to bring the level of public services per capita back to 2008 levels, then by 2013 projected spending could exceed projected revenue by as much as $2.0 billion.

The recent state fiscal crisis, the economy, and state revenue

- The state fiscal crisis experienced in a large number of states from 2001 to 2003 was caused by a relatively modest recession combined with end of the stock market bubble and the impact of tax cuts enacted in the late 1990s. Both led to steep declines in state revenue.
- During economic downturns, it is common for state revenue to grow more slowly than population and inflation, but usually state revenue continues to grow at least slightly when measured in current dollars. During the state fiscal crisis, however, many states experienced declining revenue even in current dollars.
- In South Carolina, General Fund revenue in current dollars dropped from $7.1 billion to $6.9 billion in 2008, a 3.1 percent decline. The year-end budget was balanced by drawing on the Capital Reserve Fund, the General Reserve Fund, and surplus revenue from the previous year.
- By August 2008, 15 states, South Carolina included, had made cuts to their 2009 budgets.
- For the 2009 fiscal year, the South Carolina Board of Economic Advisors estimates South Carolina General Fund revenue at $6.6 billion ($6.0 billion when revenue for tax relief is excluded), a decrease over the previous year that falls well short of combined growth in population and inflation. In October 2008, the General Assembly implemented $488 million in targeted budget cuts only four months into the fiscal year.
- The current economic downturn increased fiscal stress on states that have not recovered fully from the earlier state fiscal crisis. In 2007, the last year before the current downturn, average real state tax revenue per capita was 4.8 percent lower than it was in 2000. In South Carolina, the gap was even larger—8.9 percent below its 2000 level.

Current challenges: Revenue

- Revenue to the South Carolina General Fund is vulnerable to the effects of economic downturns because of recent legislative changes in the tax structure.
- The elimination of the sales tax on food reduced current and future revenue from the retail sales tax. Revenue from the retail sales tax in fiscal year 2008 was 6.3 percent lower than it was in 2007, a decrease of $165 million. Part of the decline was due to elimination of the sales tax on food. The remainder to a slowdown in consumer purchasing as increases in the cost of food and fuel have forced consumers to cut back on other purchases that are subject to sales tax.

- Several changes in the individual income tax reduced current and future revenue, including the flat 5 percent rate on income from unincorporated businesses and the elimination of the lowest tax bracket for all taxpayers. Individual income tax revenue was only down 0.6 percent in fiscal year 2008, but a part of that revenue was based on 2007 income tax returns filed in 2008. Revenue from this tax may decline more sharply into fiscal year 2009 as people file their 2008 income taxes, which will more closely reflect current economic conditions.
- The current housing crisis has depressed home values and slowed new construction in the state. Depressed home values will result in lower assessments and lower local government revenue from the property tax. The slowdown in construction reduces purchases of building materials, carpeting, appliances, paint, landscaping materials, etc., which also affect state and local sales tax revenue.
- South Carolina's above average unemployment rate (7.6 percent in August 2008) will mean declining personal income and individual income tax revenue. The downturn in the stock market, also partly influenced by the housing crisis, will result in less income tax revenue from capital gains.
- Revenue from excise taxes on alcohol and tobacco continues to decline as a share of state General Fund revenue because the taxes are fixed on a per unit basis (per gallon, per pack) rather than as a percent of the price, so revenue does not keep pace with inflation. The drop in fuel consumption resulting from high fuel prices has reduced revenue from the motor fuel user fee. Revenue from this excise tax is collected separate from the General Fund.
- South Carolina is no longer collecting revenue from the estate tax because of changes in the federal law to which the state has not yet responded.
- Corporate income tax revenue was the only bright spot in fiscal year 2008, up 4 percent over the previous year, largely a result of higher exports.

Current challenges: Spending

- The state remains highly vulnerable to the effects of economic downturns because of legislative spending commitments created in the last few years.
- All states, including South Carolina, continue to face rising expenditure demands on many fronts, but particularly in health care and education. The impact of declining sales tax revenue is particularly troublesome for elementary and secondary education in South Carolina, which became much more dependent on the sales tax for funding starting in fiscal year 2008 as a result of Act 388 of 2006.
- General fund appropriations for health and social rehabilitation, most of which fund the state's Medicaid program, grew at an average rate of 5.6 percent a year over the past decade. Spending demands in this area are expected to grow at least this fast over the next few years. State General Fund revenue grew more slowly at 4.5 percent a year. Health care costs for state employees and state retirees continue to grow at rates exceeding the growth of overall state revenue. As the population continues to age, health costs and especially Medicaid funding has become a serious concern for many states, but particularly for states like South Carolina that have been popular retirement destinations.
- While the property tax is a local tax, the commitment to fund property tax relief for the elderly and for homeowners is a state obligation. Part of that property tax relief is funded with tax revenue that would otherwise be available to the General Fund. The

one-cent increase in the state retail sales tax is expected to generate enough revenue to fund the expanded commitment to eliminate all school operating taxes on owner-occupied residential property, but even in its first year the cost of funding the program was greater than expected, requiring a transfer from the General Fund.

- Cuts in spending for public education during the state fiscal crisis have not yet been fully restored, despite pressing needs to improve educational services particularly for minority, low-income and special needs children. Act 388's effect on revenue from owner-occupied residential property as well as caps on property tax rates (millage) and property assessments have limited the ability of local school districts to replace that funding at the local level.
- The reduction in state support for higher education has shifted much of the burden to students' families. Lottery-funded scholarships have helped in some cases, but state institutions are increasingly becoming out of reach for average families and average students.
- Despite the lessons of the recent state fiscal crisis, the General Assembly has not yet acted to strengthen the reserve funds needed to maintain services when there is a revenue shortfall. While the national recommended standard for reserve funds is a minimum of 10 percent of the previous year's adopted budget, South Carolina's two reserve funds together are set at only 5 percent.
- Legislation was proposed but not enacted in the 2008 legislative session that would limit growth of state General Fund spending to the average rate of revenue increase over the preceding 10 years, with any excess funds diverted to a reserve fund. Such legislation would greatly strengthen the ability of the state's General Fund to withstand cyclical economic downturns.

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INTRODUCTION

What a difference a year makes in the condition of the economy! In summer 2007, the economy seemed stable—at least on the surface. Real (inflation-adjusted) personal income was growing at a moderate pace and unemployment rates were declining in South Carolina and other states. A year ago many of us were just learning about housing market problems caused by subprime mortgage interest resets and loan foreclosures. We had not yet heard of credit default swaps and federal bailouts.

What a difference a year makes in the condition of state government revenues and budgets! Most states ended fiscal years 2005-06 and 2006-07 with revenues on target with or exceeding budgeted spending. But in fiscal year 2007-08, which ended in most states on June 30, states saw slow revenue growth, particularly from the sales tax (Boyd and Dadayan, 2008). As that fiscal year was coming to a close, 20 states were expecting revenue collections below expectations and 13 states had already made mid-year budget cuts (NGA/NASBO , 2008). In fiscal year 2008-09 budgets, 29 states cut spending, used reserve funds, or raised taxes and/or fees in order to adapt to lower revenue expectations. By August 2008, only three months into the fiscal year, 15 states, including South Carolina, were already facing revenue shortfalls in adopted budgets (McNichol and Lav, 2008). In October 2008, the South Carolina General Assembly convened in special session to reduce General Fund appropriations for fiscal year 2008-09 by $488 million.

The coming year will be a challenging one for South Carolina and other states. Policy makers have difficult decisions to make about which services to cut in the face of current (and likely future) revenue shortfalls and will be faced with a great deal of revenue uncertainty when planning for the next fiscal year's budget. The current instability in the national and international financial markets makes it impossible to accurately predict the condition of the national economy and its impact on state revenue collections and state spending obligations at some future date. But given current trends, South Carolina and other states could face a fiscal crisis of at least the magnitude of the one associated with the 2001 recession.

Beyond the current crisis, however, it is important that the state adopt policies that improve the fiscal sustainability of its revenue system. Recent changes in the tax structure have made the South Carolina General Fund more vulnerable to economic downturns. This report examines trends in state revenue and expenditures, especially during the last recession, and identifies current challenges to revenue and spending. The report also examines whether or not the state's revenue system is likely to be able to support future spending. Comparisons of South Carolina with national trends are based on state revenue data from the United States Census Bureau. Within the state, our focus is primarily on the General Fund, because that is the revenue available to fund the annual budget enacted by the General Assembly. South Carolina data are from the Budget and Control Board's Board of Economic Advisors and Office of State Budget.

Fiscal Sustainability and State Budget Policy

A fiscally sustainable revenue system is a structure of revenue streams, spending obligations, and reserve funds that allow government to maintain an acceptable level of public services over the long term and through fluctuations in economic activity. A fiscally sustainable state revenue system will:

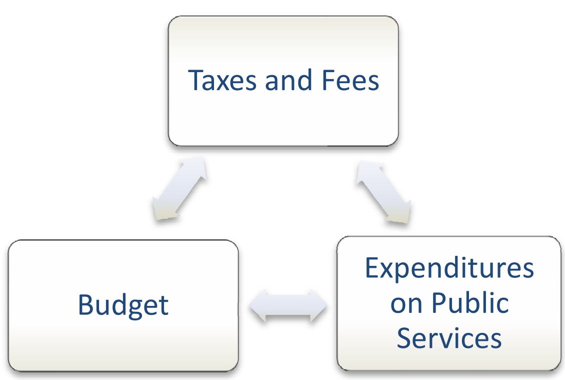
- Raise adequate revenue to pay for desired services
- Raise revenue from a mix of sources while keeping tax rates low
- Increase revenue at a rate no less than population growth plus inflation
- Be prepared for unanticipated spending needs and revenue shortfalls

A fiscally sustainably revenue system will contain a mix of revenue sources that provide a stable foundation so that revenue grows as the economy grows. A mix of sources ensures that revenue collections are more stable when the economy is in recession. The individual income tax and the retail sales tax are more sensitive to changes in the economy than property taxes, fees and service charges.

A mix of revenue sources also helps keep tax rates low. High tax rates discourage people and businesses from locating, working, or shopping in the state. Finally, a mix of revenue sources helps to distribute the tax burden fairly among households of different income levels and between businesses and households.

In order to maintain current public service levels, spending must, at a minimum, keep pace with population growth plus inflation. Fiscal sustainability requires that revenue growth also keep pace with population growth plus inflation so that *real* (inflation-adjusted) per capita revenue available to pay for services is at least unchanged. If some important government services, such as health care, are experiencing higher rates of inflation, revenue may have to grow faster than population plus inflation in order to sustain the same level of those services.

A fiscally sustainable revenue system will also incorporate preparations for unanticipated spending needs and revenue shortfalls. For example, all state agencies (especially the Department of Education) were hard hit during the past year with rapidly rising fuel costs, especially for diesel. The state has reserve funds to cover revenue shortfalls during economic downturns, but they are not adequate for any more than the most minimal and brief decline in state revenue.



The fiscal sustainability of a state revenue system is determined in large part by state budget policy. State budget policy consists of decisions about the revenue structure, about appropriation of public funds, and about borrowing and capital spending. While most citizens are concerned about such public issues as education, health care, highway safety, and environmental quality, the budget is the bedrock on which all these issues come to rest. The state must have the financial resources to provide these and other critical public services. The state must also have a budgeting policy that ensures that priorities for public spending are carefully set and are reflected in the budget.

State budgetary policy is complicated by a number of factors. The budget is based on estimates of future revenue, which may fall short of or exceed estimates. The state of South

Carolina is required to balance its budget, even when actual revenue collections do not meet appropriations based on estimates. Actual revenue collections result from the interaction between the structure of taxes and fees set by the General Assembly and the performance of the underlying economy. The two primary sources of state revenue to the General Fund, the individual income tax and the general retail sales tax,[1] have provided long term revenue growth but are also very vulnerable to fluctuations in economic activity. In addition, legislators need to be cautious about spending every dollar of estimated revenue—or returning some of it in expanded tax relief—in good years in order to avoid precipitating a fiscal crisis in the next economic downturn.

[1] Four percent of the sales tax's six percent rate is revenue to the General Fund. The fifth penny is earmarked for the Education Improvement Act Fund and the new sixth penny is earmarked for the Homestead Exemption Fund for homeowner property tax relief.

Economic Trends and State Revenue

The Business Cycle

The effect of changes in economic activity on state revenue is familiar to most citizens. The ups and downs of state revenue (and budgets) reflect two overlapping trends, a cyclical swing in revenues over the course of the business cycle and a secular or long term trend, which is generally upward (Figure 1). During expansions, revenue growth speeds up, fueled by rising incomes and higher spending. During recessions, revenue growth slows as the economy contracts and households and businesses have less income and cut back on spending, affecting both sales and income tax revenue. In some recession years, state revenue actually declines, although more often it just grows more slowly than inflation, population and spending needs.

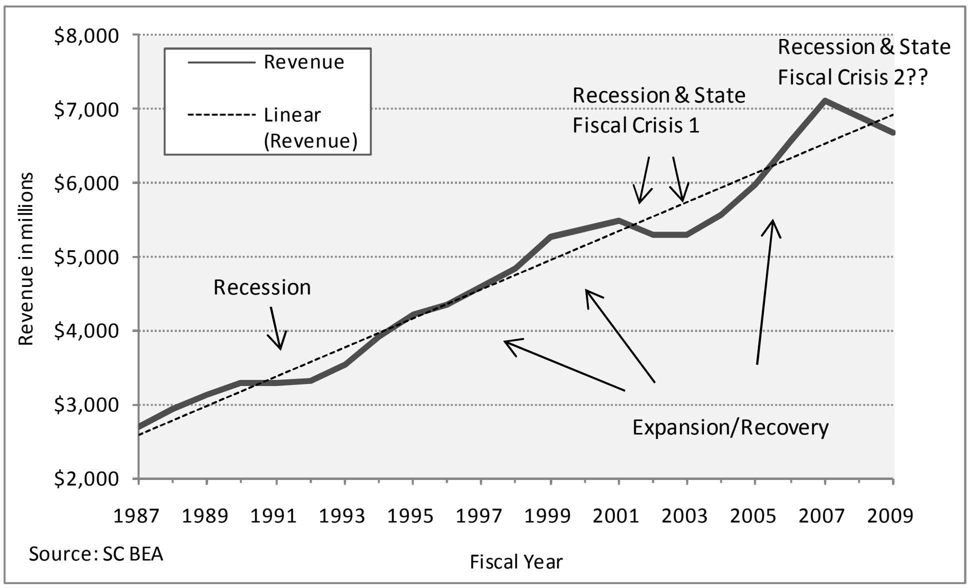


Figure 1. South Carolina General Fund, revenue, 1987-2007

Like most states, South Carolina's economy is open rather than self-contained. The state imports a large share of what it consumes and exports a large share of what it produces. As a result, changes in state personal income and in state gross domestic product (GDP), the two measures of state income and output, are both closely tied to changes in the national and even the international economy.

Long term trends in state revenue growth are generally positive and closely track growth in personal income, GDP, and population. The mid 1990s through 2000 were boom years for most state economies. Between 1994 and 2000, state personal income and GDP by state grew well over five percent a year in most years in the average state, including South Carolina. State tax revenue growth followed suit with a lag, as some revenue collections, especially from the individual income tax, reflect the prior year's tax base (Figure 2).[2] Both the 1990 recession and the 2001 recession are clearly visible in each of these measures. Although both of these recessions lasted only eight months, their effects on state tax revenue were longer-lasting.

[2] Rapid state tax revenue growth after the 1990 recession resulted from improving economic conditions as well as enacted tax increases. Fewer tax increases were instituted after the 2001 recession.

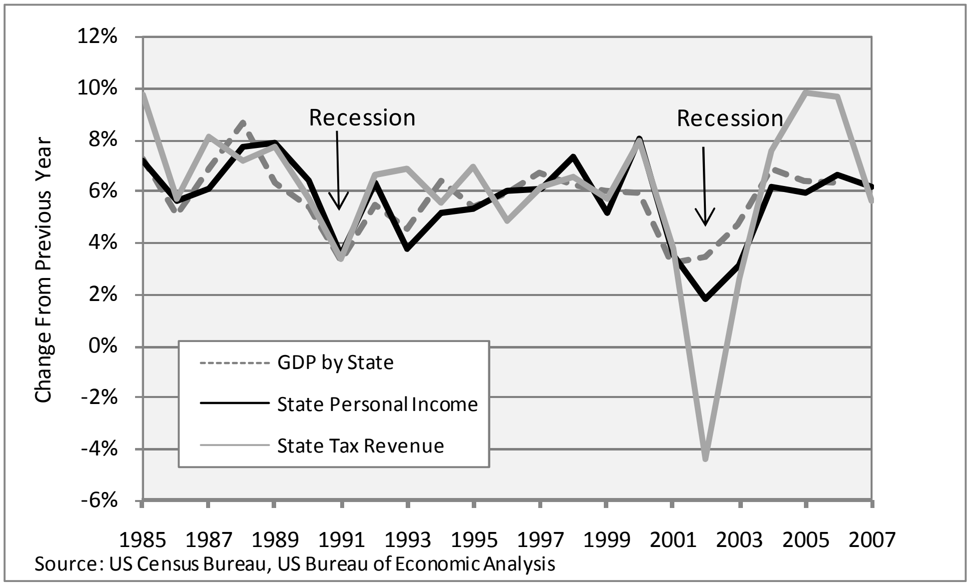


Figure 2. Annual change in state GDP, personal income, and tax revenue, 1987-2007

State Tax Revenue During the Last Recession

The 2001 recession was especially hard on state revenue and budgets around the country. State tax revenue declined much more than state personal income and GDP (Figure 2). For this reason, the years 2001 through 2003 are referred to as the *state fiscal crisis.*

The 2001 recession was especially hard on state revenue and budgets.

In 2002, South Carolina's state tax revenue was 5.1 percent lower than in the previous year.[3] Average state tax revenue declined 4.4 percent across the nation. It is rare for state tax revenue to decline in current dollars (not adjusted for inflation), but it did in 2002—the only year between 1980 and 2007 in which average state tax revenue growth was actually negative (Figure 3).

The effect of the 2001 recession on state tax revenue is even more dramatic after adjusting for inflation and population growth.[4] Between 2001 and 2002 , the average state's inflation-adjusted, or real, state tax revenue per capita dropped by 7.6 percent (Figure 4). This drop was more than twice as steep as the decline in the two preceding recessions (Boyd, 2003). In South Carolina, the fall was even more dramatic at 8.4 percent.

To maintain a constant level of public services, revenue needs to grow at about the same rate and population and inflation. If revenue lags behind that combined growth rate, either tax increases or service cuts will result. If revenue grows faster than population plus inflation, it is possible to improve the quality or the kinds of public services without an increase in tax rates.

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[3] State tax revenue data collected by the U.S. Census contains revenue from the motor fuel tax and other taxes which may be earmarked for uses outside the state General Fund, as is the case in South Carolina.

[4] Economists adjust revenue figures for growth in the price level (inflation) and growth in population in order to get a year-to-year comparable measure of revenue resources available for public use. Although revenue and spending in current dollars is most commonly reported, for policy purposes the inflation-adjusted revenue or spending per capita is the most useful measure of what is happening to funding for public services and agencies.

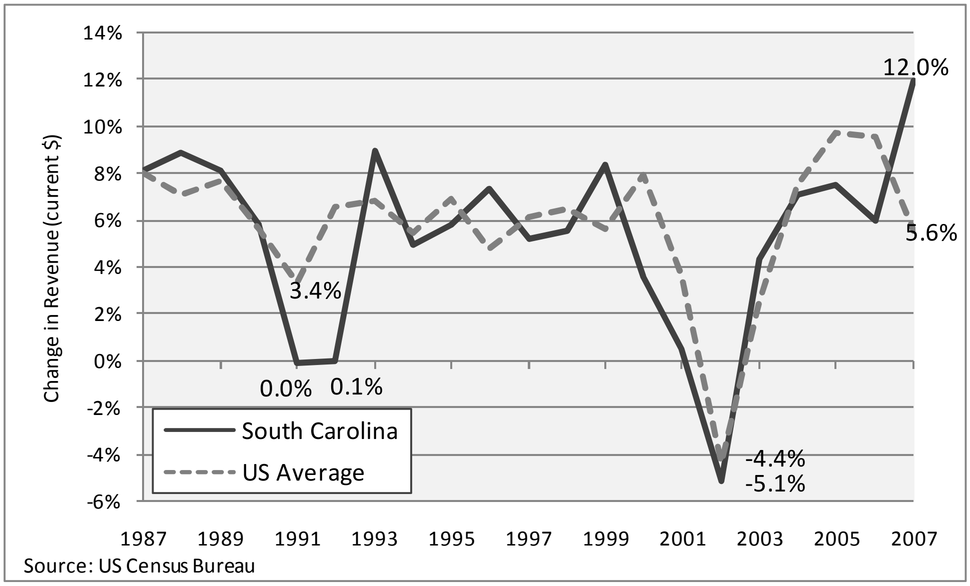

Figure 3. Annual change in state tax revenue, SC and US, 1987-2007

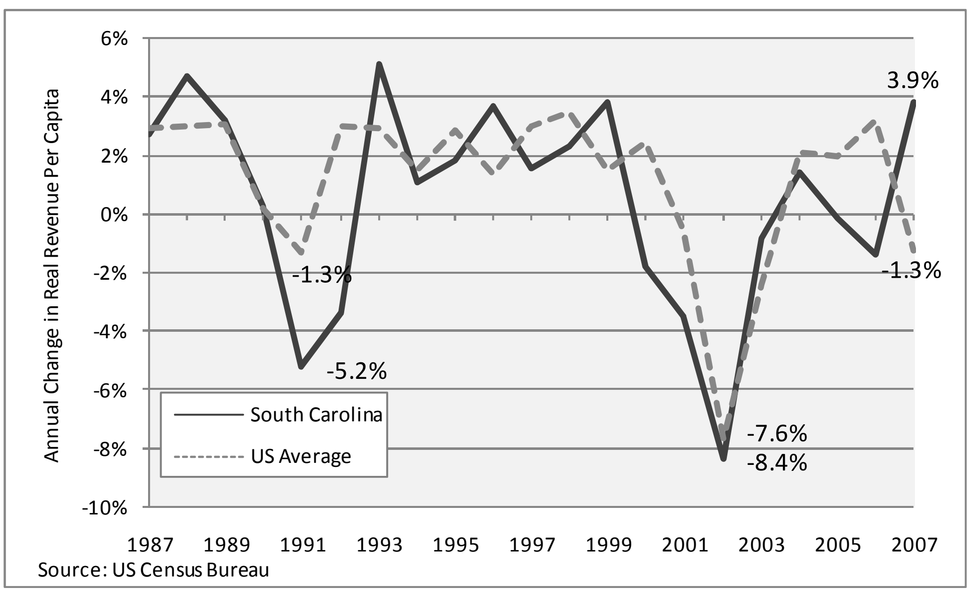

Figure 4. Annual change in real state tax revenue per capita, SC and US, 1987-2007

What Caused the State Fiscal Crisis of 2001 to 2003?

The state fiscal crisis that began in 2001 was not just the result of a weakening economy. The stage was set by economic trends and state policy decisions made during the 1990s. Understanding the causes of the recent state fiscal crisis can help states plan to avoid such serious revenue declines when the business cycle turns down.

The late 1990s were boom years for most state governments, including South Carolina. The economy was strong and incomes were on the rise. The stock market more than tripled in value between 1994 and 2000. As investors sold depreciated stock, especially toward the end of the decade, state (and federal) income tax collections rose dramatically. An increase in consumer spending as a share of income, fueled by capital gains, resulted in higher sales tax collections as well (ibid.).

Legislators around the country responded to the revenue bonanza with various kinds of tax cuts and tax relief as the preferred way to use surplus funds. Between 1994 and 2001, 44 states (including South Carolina) made significant tax cuts, primarily in income and sales taxes (Center on Budget & Policy Priorities, 2004). More states also exempted food from the sales tax, a trend that South Carolina finally joined in 2006 and 2007.

Between 1994 and 2001, 44 states (including South Carolina) made significant tax cuts, primarily in income and sales taxes.

A relatively modest recession combined with end of the stock market bubble and the revenue impact of earlier tax cuts resulted in sharp declines in state revenues in 2001, 2002, and 2003. State legislatures were less willing to raise taxes to balance budgets than they were in the recession in the early 1990s. Instead, most states cut spending after exhausting their reserve funds (Orszag 2003; Maag and Merriman 2007).

The state fiscal crisis was also intensified by spending pressures for health care and especially Medicaid. Between 1990 and 2000, Boyd (2003) estimated that combined federal and state real per capita spending on Medicaid grew 6.5 percent a year on average, much faster than spending in other major budget areas. These revenue and spending factors combined with the recession resulted in mid-year budget gaps in 38 states in 2002 and in 40 states in 2003, including South Carolina.

Today's Troubled Economy

Storm clouds are here again. Growth in the national and South Carolina economies has slowed, the unemployment rate has increased, and rising food and fuel prices are affecting household and business purchasing. Unemployment rates, which had been dropping nationally since 2003 and in South Carolina since 2005, began climbing in 2007. In South Carolina, the unemployment rate jumped to 7.6 percent in August 2008—its highest level since May 1993.

Primary contributors to the state's unemployment rate were a drop of 12.25 percent in employment in construction over the past year combined with a slower, but long term, decline in manufacturing employment. Real (inflation-adjusted) retail sales in the state dropped 2.8 percent between May 2007 and May 2008. Economic data is on the verge of confirming that the nation is in a recession, and the forecast for the rest of 2008 and 2009 is not a rosy one (Table 1).[5]

Current State Revenue Trends

The faltering economy is evident in state revenue receipts in South Carolina and around the country. The Rockefeller Institute of Government reports that overall real state tax revenue, adjusted for inflation and legislative changes, started to decline in the second half of 2007 and continues to decline (Boyd and Dadayan, 2008). The Rockefeller Institute also predicts a continued slowdown in state tax revenue growth into the near future. Growth in both taxable income and goods consumption slowed sharply through June 2008. State individual income taxes for tax year 2008 will reflect this decline in 2009, as will sales tax receipts in the current year.

[5] The National Bureau of Economic Research defines a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.

Table 1. Near Term Forecast of US and SC Economic Indicators

Economic Indicator	Forecast
The Conference Board (October 2008)	
U.S. real GDP	Declining from 3rd quarter 2008 through 2nd quarter 2009
U.S. unemployment rate	Increasing to 7% by 2nd quarter 2009
U.S. real consumer spending	Declining from 3rd quarter 2008 through 2nd quarter 2009
University of South Carolina (June 2008)	
S.C. real personal income	Growth slowing into 2009
S.C. unemployment rate	Increasing into 2009
S.C. building permits	Declines through 2008, growth in 2009

Source: South Carolina Economic Outlook June 2008, Moore School of Business, University of South Carolina, and The U.S. Economic Forecast October 8, 2008, The Conference Board, www.conference-board.org.

South Carolina was one of only six states to have April 2008 first quarter estimated income tax payments lower than those for the same quarter in 2007, which does not bode well for tax receipts in the first half of 2009, when final tax payments for the previous year are made (Boyd and Dadayan, 2008). Sales tax revenue growth continues to be adversely affected by low consumer confidence and high fuel and food prices as consumers shift their spending to these essential but (mostly) untaxed goods and away from discretionary items subject to the sales tax.

The state revenue situation quickly worsened over the spring and summer months of 2008. In September 2008, the Center on Budget and Policy Priorities (McNichol and Lav, 2008) reported that 15 states and the District of Columbia were experiencing revenue shortfalls in adopted budgets for fiscal year 2008-09. The states that have escaped revenue shortfalls to date are those with revenue from mineral and energy resources and those states less affected by the decline in housing prices and the aftermath of the subprime mortgage lending crisis. Newspaper articles from around the country have documented how quickly many state budgets have gotten into trouble as revenue receipts have slowed.[6]

Only three months into fiscal year 2008-09, 15 states and the District of Columbia were experiencing revenue shortfalls, South Carolina included.

Current State Revenue Trends in South Carolina

South Carolina has not escaped the national pattern of state budget difficulties. In November 2007, the South Carolina Board of Economic Advisors (BEA) estimated that General Fund revenue would be slightly lower than revenue in the previous year because of legislative changes to the individual income tax and the retail sales tax. This estimate was made just as the subprime mortgage crisis was starting to impact other sectors of the economy. Revenue slowed dramatically in the second half of fiscal year 2007-08—particularly revenue from the sales tax—and final General Fund revenue collections for the fiscal year fell $205.4 million short of the BEA's midyear estimate.

[6] See www.stateline.org for weekday reporting on state taxes and budgets and other topics.

In April 2008, the BEA reduced its revenue estimates for 2007-08 and 2008-09 by $90 million each and reduced the 2008-09 estimate by an additional $140 million in July 2008. The South Carolina Budget and Control Board (BCB), the governing body that sets budgetary policy for the state, took action to balance the General Fund budget at the close of fiscal year 2007-08 by drawing down almost 70 percent of the state's budgetary reserve funds and using surplus revenue from an earlier year (Table 2).

In August 2008, the BCB took action to rein in current year spending by directing state agencies to cut three percent ($187 million) from their General Fund budgets in anticipation of continued revenue shortfalls throughout the fiscal year. The BCB also sequestered the state's $133 million Capital Reserve Fund, which is the state's first line of defense against year-end revenue shortfalls.

In October 2008, the BEA reduced its General Fund revenue estimate by an additional $414 million. State legislators met in special session in late October 2008 to make targeted cuts to the current budget in the amount of $488 million, in lieu of the earlier three percent cut. State agencies endured four straight years of across-the-board budget cuts during the recent state fiscal crisis. The BEA's just-released November 2008 detailed General Fund revenue estimates for fiscal years 2008-09 and 2009-10 put current year revenue $345 million below last year's collections. The 2009-10 estimate of $6.6 billion (funds for tax relief included) will be the starting point for fiscal year budget deliberations when the General Assembly convenes in regular session in January 20090.

Table 2. What a Difference a Year Makes

Year	Revenue to the South Carolina General Fund*
2006-07	$7,124.8 million collected in General Fund revenue. $537.9 million higher than 2005-06 revenue (8.2% increase). Sales tax revenue up 5.1%. Individual income tax revenue up 11.8%.
2007-08	$6,902.4 million collected in General Fund revenue. $222.4 million less than 2006-07 revenue (3.1% decrease). Year-end sales tax revenue down 6.3% from April 2008 estimate. Year-end individual income tax revenue down 0.6% from April 2008 estimate. Drawdowns of Capital Reserve Fund ($124 million), General Reserve Fund ($73 million), and surplus revenue ($34 million) used to balance year-end budget.
2008-09	November 2007: General fund revenue estimate at $7,336 million. April 2008: Revenue estimate reduced by $90 million to $7,246 million. July 2008: Revenue estimate reduced by $140 million to $7,106 million. August 2008: Budget & Control Board directs state agencies to cut 3% from their budgets ($187 million) and Capital Reserve Fund ($133 million) sequestered in anticipation of year-end revenue shortfall. October 2008: Revenue estimate reduced by $414 million to $6,692 million. Sales tax revenue down 12.4% over July to September level in prior year. Individual income tax revenue nearly flat over July to September level in prior year. General Assembly convenes in special session to make $488 million in targeted cuts to state agency budgets. November 2008: Revenue estimate reduced by $135 million to $6,557 million.

*Totals include revenue that will be transferred out of the General Fund to the Trust Fund forTax Relief (estimated at $531.1 million in fiscal year 2008-09).

The outlook for future growth in state sales tax revenue and individual income tax revenue is not promising. National personal consumption expenditure (PCE) estimates for the July to September 2008 quarter by the Federal Reserve Bank of St. Louis show a steep decline in real (inflation-adjusted) PCE on goods and services. If confirmed, this will be the first quarter of negative real PCE growth since the recession in 1991. PCE is a proxy for spending on taxable goods.

In South Carolina, individual income tax withholding grew at 1.4 percent in the second quarter of 2008, less than half the rate of the previous three quarters. Withholding is a good measure of current income from wages and salaries. South Carolina is also one of seven states that had year-over-year declines in estimated tax payments in the first two quarters of 2008. (Boyd and Dadayan, 2008) Estimated tax payments are made on income not subject to withholding, such as investment income and capital gains. The current volatility in the financial markets and recent large drop in market value in many stocks make it likely that estimated tax payments will see further declines.

Current Budgetary Challenges for States

States face ongoing challenges on both sides of the budget. State revenue began recovering from the fiscal crisis in 2004, but the recovery was slower than after the 1990 recession (Jenny, 2005). The steep decline in revenue meant that more ground had to be made up, and fewer states chose to do so by enacting tax increases.

On the spending side, the weak economy and slowing state tax revenue growth continues to make state budgeting difficult. While economists and budget analysts develop revenue estimates as accurately as possible, they cannot anticipate many kinds of shocks, such as the recent run-up in motor fuel prices, rapid decline in the stock market and lack of liquidity in the credit markets. State and federal laws and regulations may increase state spending obligations regardless of states' ability to raise additional revenue. State population growth also drives base spending obligations to the extent that state agencies attempt to maintain current service levels. Below is a discussion of some major challenges that will affect state budgets over the next few years.

Lower Purchasing Power of State Tax Revenue

The purchasing power of state tax revenue was eroded by the last recession and has only recently regained the inflation-adjusted levels of a decade ago. The decline in South Carolina's real state tax revenue per capita during the state fiscal crisis was steeper than in the average state and has taken longer to recover. In South Carolina, the purchasing power of state tax revenue in constant 2000 dollars dropped from a high of $1,620 per capita in 1999 to $1,396 in 2003 and again in 2006 (Figure 5). For all states, the revenue decline was from $1,922 per capita in 2000 to $1,724 in 2003. In 2007, average real state tax revenue per capita was 4.8 percent lower than it was in 2000. In South Carolina, the gap was even larger at 8.9 percent below its level of $1,591 in 2000.

The purchasing power of state tax revenue was eroded by the last recession and state fiscal crisis and has only recently regained the inflation-adjusted levels of a decade ago.

The current economic down turn has followed relatively quickly on the heels of the state fiscal crisis. The last three recessions—early 1980s, early 1990s, and early 2000s—were each separated by about a decade, which gave states time to recover revenue and to rebuild programs that were cut to balance budgets. Today states are experiencing the effects of the current downturn with fewer resources available to combat the adverse effects of slowing revenue and rising costs.

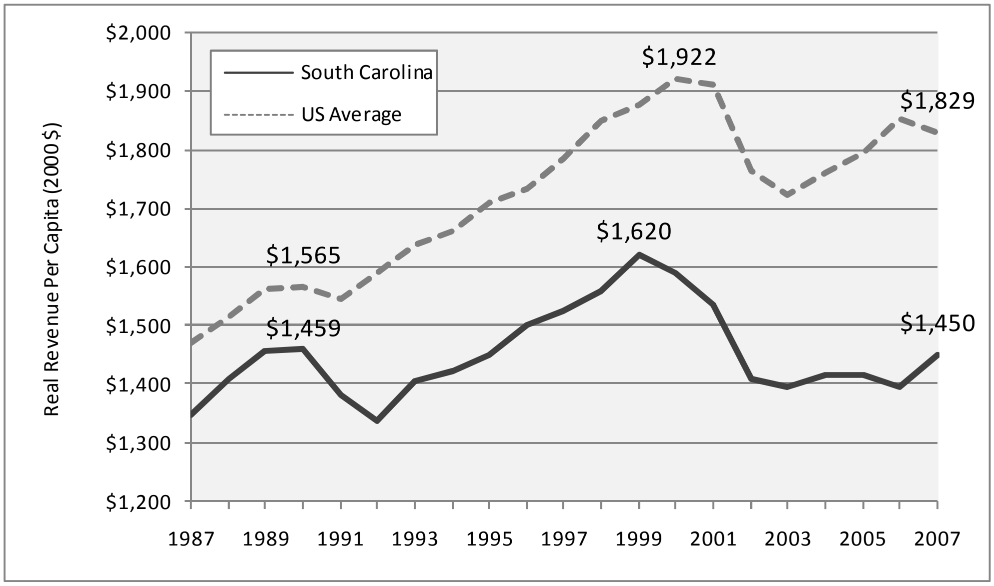

Figure 5. Real state tax revenue per capita, SC and US, 1987-2007

The Housing Market

The current economic slowdown is caused in part by the sharp decline in the housing market and the crisis in the sub-prime mortgage market. The South Carolina Association of Realtors reports that total sales of new and existing homes in the state nearly doubled between 2001 and 2005. But interest rates began to climb in late 2004 and by mid 2006, total home sales started to decline and have continued that trend into 2008. The median sales price of a home in South Carolina, which had increased 30 percent between 2001 and 2006, declined in 2008 (Figure 6).

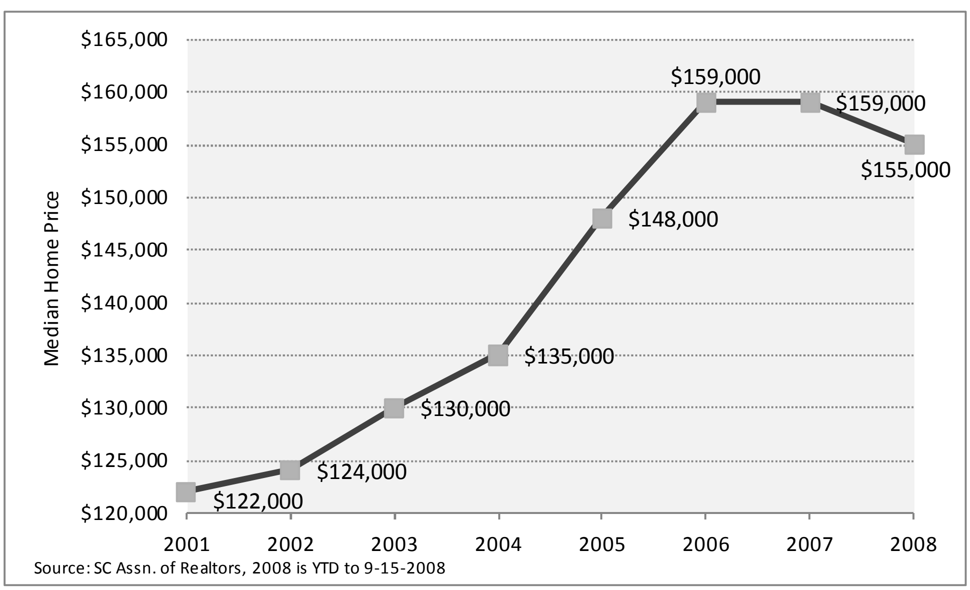

Figure 6. South Carolina median home price, 2001-2008

While new home construction and changing housing values directly impact local property taxes, they also affect economic growth and state taxes. The housing market is a major driver of many kinds of household spending. A continued decline in new home construction and construction employment, and a decline in consumer spending by those who have been borrowing on their home equity and have no more borrowing capacity, will affect revenue from both the individual income and retail sales taxes, especially sales taxes on building materials and other goods such as carpet, furniture, and appliances. Local governments can be expected to seek higher levels of state aid to help replace declining property tax revenues as new homes go unsold and existing homes lose value, and as local sales taxes yield less revenue.

Declines in home construction and employment, housing values, and consumer spending on housing affect revenue from the individual income tax, state and local sales taxes, and the local property tax.

Nationwide, the decline in residential investment subtracted about one percentage point from real GDP growth in 2007, and lowered growth by another percentage point in the first quarter of 2008. The 2.9 percent vacancy rate for owner-occupied housing in the first quarter of 2008 was at its highest level in 52 years (Lacker, 2008).

The Price of Energy

In 2008, the price of a barrel of oil soared to over $140 a barrel and the price of a gallon of gasoline topped $4 and hope is fading for a return to the much lower prices of only a few years ago (Figure 7). Between 2001 and 2006, prior to the latest run-up in fuel prices, the price of energy of all types used in all sectors of the U.S. economy increased close to 60 percent, according to the U.S. Bureau of Economic Analysis. The price of energy used by state and local governments increased 87 percent over the same period, likely reflecting government's relatively higher reliance on motor fuel for agency operations.

Between the first quarter of 2006 and the first quarter of 2008, the price index for the energy component of personal consumption spending (gasoline, fuel oil, and other energy goods) rose from 160 to 216, an increase of 35 percent in just two years. Over the same period, the index for personal consumption expenditures excluding food and energy rose only five points, from 111 to 116, an increase of less than 5 percent. The cost of energy remains relatively high and spills over into a higher cost for goods manufactured and transported with more expensive energy.

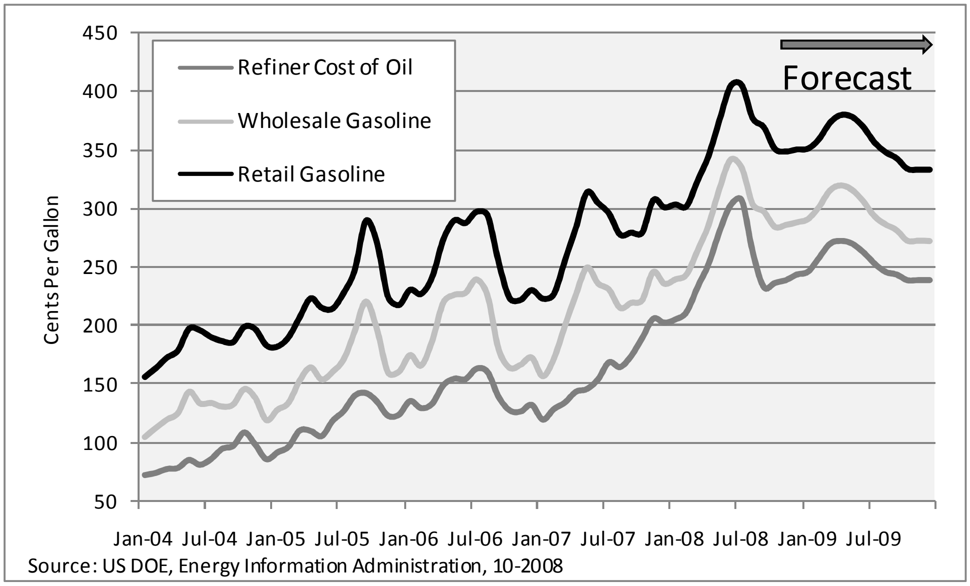

Figure 7. US crude oil and gasoline prices (taxes included)

Energy costs do not appear as a line item in state budgets, but they affect every public agency, program, and employee because heating, cooling, and especially transportation are important at all levels of government. In 2007-08, the South Carolina Department of Education spent over $37 million on fuel for school buses at an average cost of $2.96 a gallon.[7] The department's 2008-09 budget for fuel is $54 million based on an average price of $4.25 a gallon—a 44 percent increase in one year alone. The General Assembly approved about $19 million in fuel cost assistance for school districts in Act 360 of 2008, but it is not expected to be adequate to cover the added costs. High energy costs will also depress state tax revenue as household and business budgets are strained and dollars that might have otherwise been spent on taxable purchases are diverted to motor fuel and other essential but untaxed spending, such as food.

Continued increases in the cost of energy will be reflected in higher government spending.

The Rising Cost of Health Care

The effect of fluctuations in economic activity on state tax revenue is only part of the budget story. The second part is the long-term trend in revenue, particularly in relation to projected expenditure needs. When revenue growth is brisk, states expand programs and/or cut taxes. States typically scale back spending or raise taxes when revenue receipts fall short of appropriations. State spending per capita may fluctuate over time for these reasons. But certain programs and services may be harder to cut than others during economic downturns, among them education and health services.

South Carolina ranked ninth out of 50 states and the District of Columbia in growth in spending on health care from 1991 to 2004.

A 2007 study by the U.S. General Accountability Office (2007) documented a widening gap between state and local revenue and expenditures over the period 1980 to 2005 that is

[7] The price of diesel fuel for school buses in South Carolina rose from $2.1478 a gallon in August 2007 to $4.2204 a gallon by the end of the school year in May 2008.

expected to extend and grow in the future. This report identifies health care as a primary driver of that widening gap, specifically Medicaid and the cost of health insurance for public employees.

The Kaiser Family Foundation (www.statehealthfacts.org) reports that the average rate of growth in U.S. public and private health care spending was 6.7 percent a year between 1991 and 2004, and 7.8 percent a year in South Carolina. South Carolina ranked ninth out of 50 states and the District of Columbia in growth in spending on health care (from 1991 to 2004) over that period. These growth rates are well above of those for state tax revenue and state personal income (Figure 8). They are also above average growth in the Consumer Price Index (2.5 percent a year) and on the CPI for medical services (4.3 percent a year).

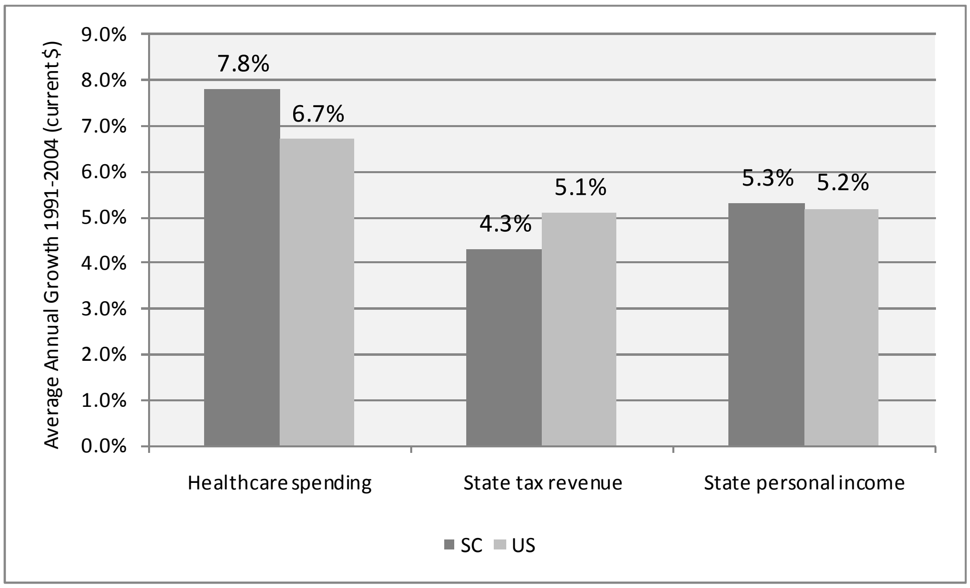

Figure 8. Average annual growth in healthcare spending, state tax revenue, and state personal income, 1991-2004

Rising health care costs directly affect growth in state Medicaid spending, which is a major driver of overall state spending because it comprises such a large share of total obligations. Economic downturns also increase the number of people eligible for Medicaid at the same time that state budgets are under fiscal stress. Despite declining economic conditions, close to half of the states considered plans to expand health coverage of uninsured individuals in their 2008-09 budget deliberations, including South Carolina (NGO/NASBO, June 2008).

Combined state spending on Medicaid and federal intergovernmental transfers to states for Medicaid became the largest single component of state spending (all states) in 2005 at 22.3 percent, surpassing elementary and secondary education at 21.8 percent (NASBO, 2007). In 2005, Medicaid took 24 percent of state-only spending, compared to 17.8 percent for education. An even higher Medicaid share is estimated for 2007. In South Carolina, combined state and federal spending on Medicaid grew at an average rate of 7.8 percent a year between 1996-97 and 2006-07. Revenue to the state General Fund grew more slowly at 4.5 percent a year over that same period.

Health insurance premiums for employees are a significant cost to states as well. They are the second largest category of health expenditure for states after Medicaid. In 2003, the average state spent 2.6 percent of its total spending on health care for employees. South Carolina's outlay in that year was higher at 3.8 percent of total spending (Millbank Memorial Fund, NASBO and Reforming States Group, 2005). In 2006-07, the employer share of health and dental insurance for current South Carolina state employees alone was $239 million, or about 27 percent of total employer contributions made, including those for retirement. Since 1990-91, state agencies in South Carolina have also paid a surcharge on current employee salaries for health and dental insurance for state retirees. The surcharge for 2008-09 is 3.5 percent, up from 1.95 percent in 1999-2000.

State spending (General Fund only) on health and social rehabilitation, a proxy for state-only Medicaid spending, grew 5.6 percent a year between 1996-97 and 2006-07. Combined state and federal spending on Medicaid grew at an average rate of 7.8 percent a year (Figure 9). Revenue to the state General Fund grew more slowly at 4.5 percent a year over that same period. Eligibility for regular Medicaid is based on age, household income and household size, with coverage for healthy, working adults limited to those with income at or below 50 percent of the federal poverty guidelines. SCHIP (State Children's Health Insurance Program) income guidelines are somewhat higher for children age 18 and under.

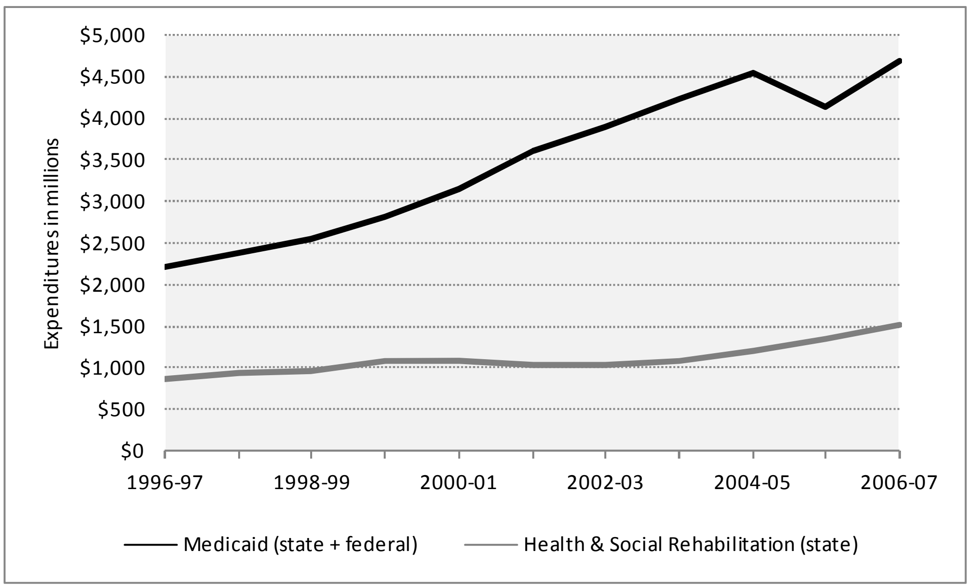

Figure 9. South Carolina Medicaid and health expenditures

After a brief slowdown in per capita Medicaid spending in 2006 as a result of state-initiated cost controls and shift of some spending to the Medicare prescription drug program, it is expected that Medicaid spending will resume its upward trend (Burke, 2007a). The Centers for Medicare and Medicaid services expect growth rates in Medicaid spending in the 7.3 percent to 8.3 percent range, well above the rate of inflation.(Burke, 2007b).

Compounding the challenges of rising health care costs and the increased number of people eligible for Medicaid during downturns are changes in federal contributions to Medicaid and SCHIP. Recently issued federal regulations restrict how Medicaid pays for a broad range of health services that will impact not only direct state spending for health care but also other social services and public education, which have a health component. Among the services for which Medicaid will no longer reimburse the states are school-based outreach and enrollment assistance for low-income children and case management services for children in foster care, even though both are required under Medicaid rules (Orris and Solomon, 2008). These changes are part of a larger policy of reduction in federal aid to state governments, which began in 2006 (Burke, 2007b). The long run projection is a continued rise in costs.

SOUTH CAROLINA GENERAL FUND REVENUE TRENDS

The South Carolina General Fund is the part of state government revenue that is subject to annual appropriations by the General Assembly. Revenue to the General Fund was $7.1 billion in 2006-07, the last fiscal year before the current economic downturn. General fund revenue desacribed in this section follows the South Carolina Board of Economic Advisors format, which includes revenue from the individual income and corporate income taxes that is transferred out of the General Fund to the Trust Fund for Tax Relief. Revenue in the General Fund from the retail sales tax does not include that earmarked for the Education Improvement Act Fund (1 percent) and the Homestead Exemption Fund (1 percent).

How are the state's revenue sources performing? Revenue growth in the General Fund averaged five percent a year over the twenty year period since fiscal year 1986-87. Although five percent a year may seem a comfortable rate, revenue growth in South Carolina just kept ahead of population growth and inflation during that period (Table 3). The General Fund took a big hit during the state fiscal crisis, and as a result, overall General Fund revenue growth over the past decade has not kept up with population growth and inflation.

Table 3. Average Annual Growth in Total General Fund Revenue

Period	Revenue (current $)	Real Revenue Per Capita (constant $)
1986-87 to 2006-07	5.0%	0.1%
1986-87 to 1996-97	5.5%	1.1%
1996-97 to 2006-07	4.5%	-0.9%
1999-2000 to 2003-04 (state fiscal crisis)	-0.5%	-4.3%

Source: SC BEA

Sales and Income Taxes

Long term revenue trends. Sales and income taxes are the mainstays of the South Carolina General Fund. In fiscal year 2006-07, revenue from sales and income taxes combined were 88 percent of total revenue to the General Fund. Over the past 20 years, the share of General Fund revenue from the individual income tax increased substantially while the share from the retail sales and use tax increased only slightly. The corporate income tax has decreased in importance in the General Fund over the last 20 years (Figure 10).

The state of South Carolina is much more dependent on revenue from the sales tax than the General Fund suggests, however. The state's retail sales and use tax[8] rate is six percent, but only four of the six percent is revenue to the General Fund. The fifth penny was added in 1985 and the revenue is earmarked for the Education Improvement Act (EIA) Fund, which supports various programs in elementary and secondary education. The sixth penny was added

[8] The retail sales tax is imposed on the sale of goods (generally tangible personal property) and some services within South Carolina. The use tax is imposed on those same goods and services when purchased out of state, brought into South Carolina, and on which no sales tax was paid at the point of purchase.

in 2007 and the revenue is earmarked for the new Homestead Exemption Fund, which replaces local school property taxes on homestead property.

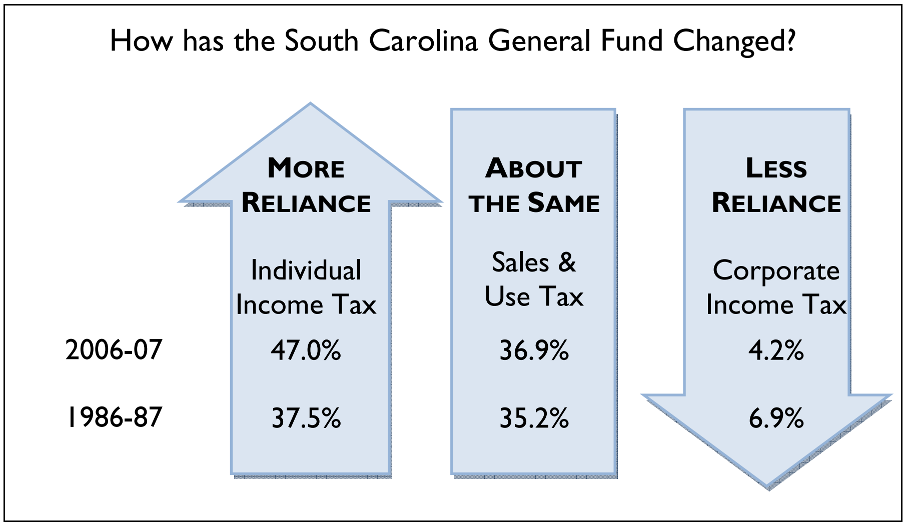

Figure 10. Changes in the South Carolina General Fund

The individual income and retail sales taxes have been large, dependable revenue sources for the state, especially during a strong economy (Figure 11). The corporate income tax has been less reliable (Figure 12). Over the twenty year period from fiscal years 1986-87 to 2006-07, revenue in current dollars from the individual income tax grew 6.2 percent a year on average. Revenue from the retail sales and use tax grew at the average rate of 5.2 percent a year (Figure 13). But even more important, over the long term revenue from the individual income and sales taxes have both more than kept pace with inflation and population growth (Figure 14).

The individual income and retail sales taxes have been large, dependable revenue sources for the state, especially during a strong economy.

Changes in revenue from individual income and retail sales and use taxes strongly influence overall revenue volatility in the General Fund because they account for so much of the total in South Carolina (and in many other states). The corporate income tax, while only a small share of General Fund revenue, is difficult to predict from year to year because it is sensitive to both changes in general economic conditions and changes in the corporate tax code. Revenue from the corporate income tax experienced one-year revenue growth or decline of 20 percent or more in eight of the last 20 years. However, its performance since the state fiscal crisis has been robust.

The weak dollar relative to other currencies, particularly the euro, has made American exports much more attractive in foreign markets. South Carolina is a state with a fairly high share of manufacturing and exports in its GSP. Increased export sales have been reflected in higher net income for at least some South Carolina corporations (as well as corporations headquartered elsewhere but with facilities in South Carolina). However, even though corporate income tax revenues are doing well in the current climate, they still represent only 4.5 percent of General Fund revenue.

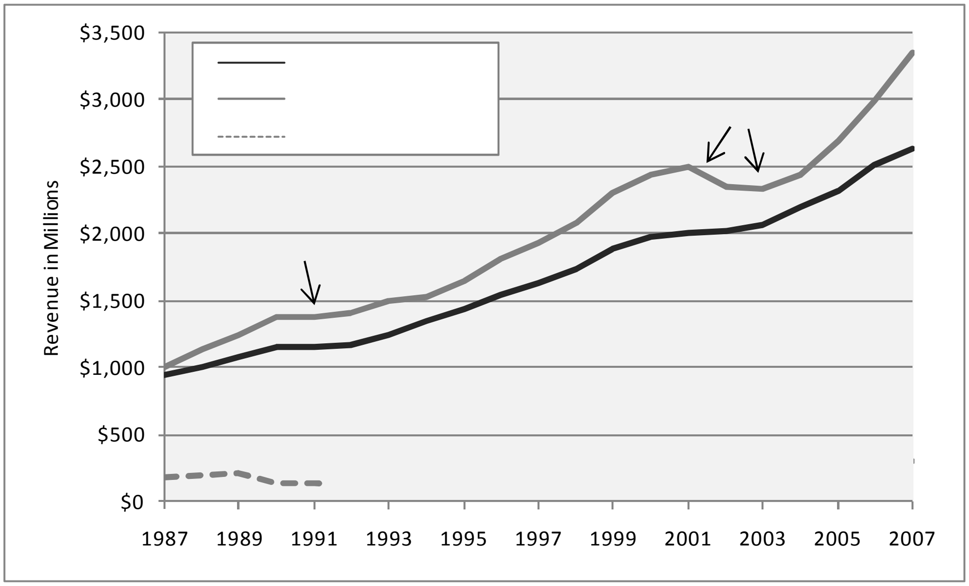

Figure 11. Sales and income tax revenue to the SC General Fund, 1987-2007

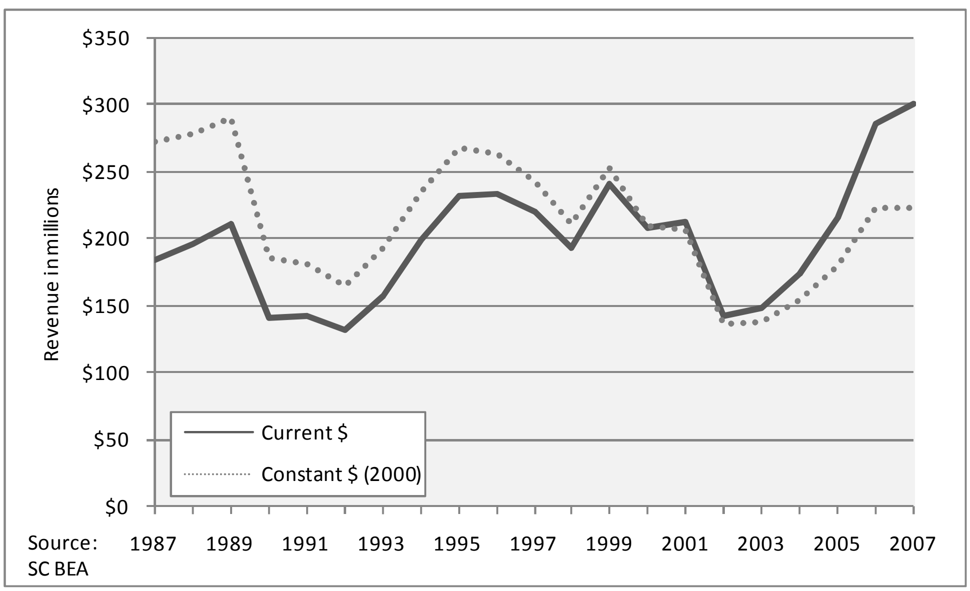

Figure 12. South Carolina corporate income tax revenue, 1987-2007

These three taxes—sales, individual income, and corporate income—are all sensitive to economic downturns. Growth in current revenue (not adjusted for inflation) from all three taxes slowed or declined during the last two recessions (Figure 13). Over the decade from 1997 to 2007, real per capita revenue from the individual income tax barely kept pace with population and inflation, while revenue from the sales tax declined in real per capita terms. Over the years of the state fiscal crisis, real per capita revenue from all three taxes declined.

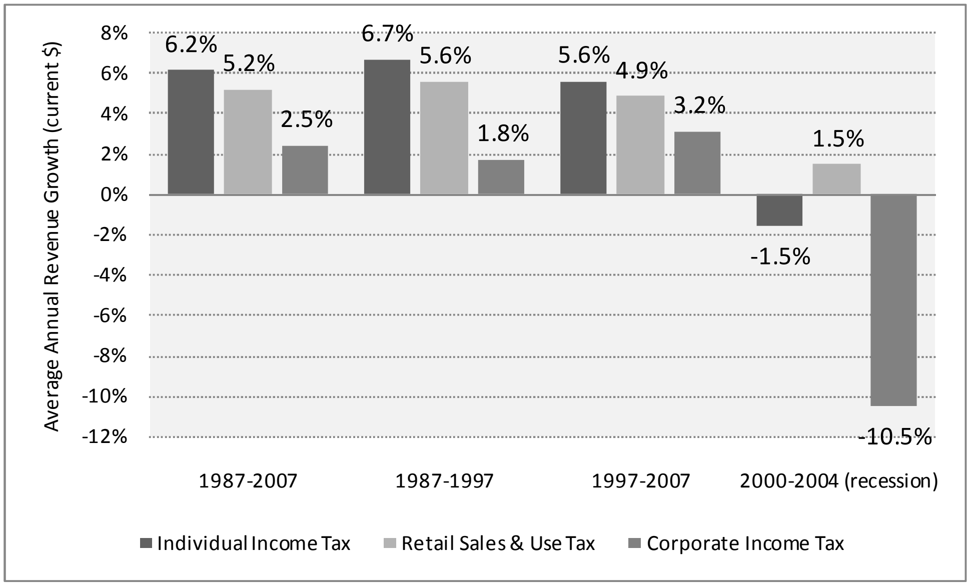

Figure 13. Average annual growth in sales and income tax revenue to the SC General Fund

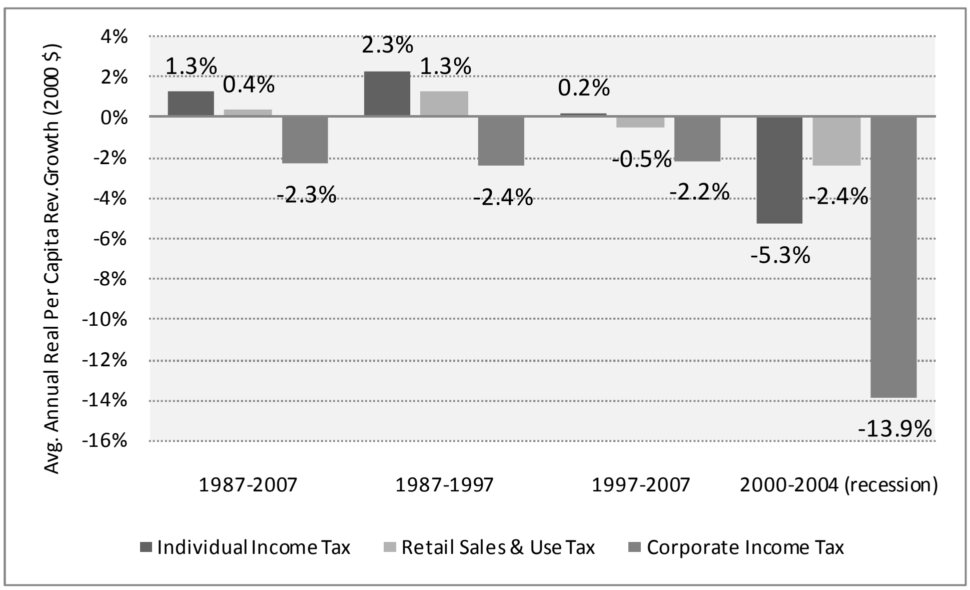

Figure 14. Average annual growth in real per capita sales and income tax revenue to the SC General Fund

Current revenue trends. Revenue to the South Carolina General Fund from the retail sales and use tax and the individual income tax is showing the combined effects of changes in state tax policy and the troubled economy (Figure 15). Revenue from the sales and use tax in 2007-08 was 6.3 percent lower than it was in 2006-07. Individual income tax revenue was only down 0.6 percent over the year, but a large share of that revenue is based on 2007 income. Revenue from this tax may decline more sharply into 2009 as people file their 2008 income taxes, which will more closely reflect current economic conditions. Corporate income tax revenue was the bright spot in 2007-08, up 4 percent over the previous year.

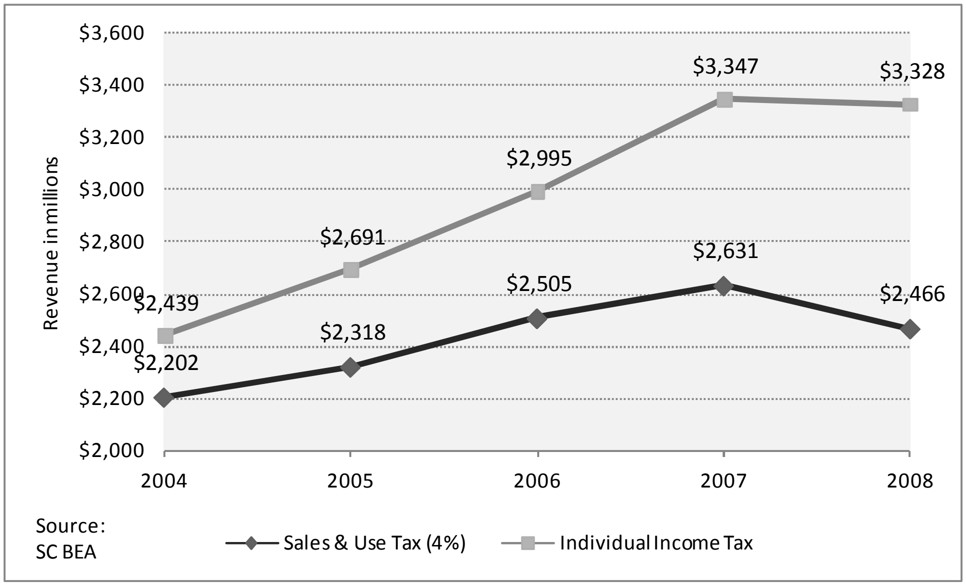

Figure 15. Sales tax and individual income tax revenue to the SC General Fund, 2004 to 2008

Revenue collections in the first quarter of fiscal year 2008-09 have been much slower than anticipated. Revenue from the retail sales and use tax was down 12.5 percent compared to the first quarter in 2007-08, and revenue from the corporate income tax is down 16.7 percent. Revenue from the individual income tax increased 0.2 percent over the previous year.

Eliminating the sales tax on food reduced sales tax revenue by $169 million in 2007-08.

Sales tax revenue is clearly affected by the downturn in the economy and high fuel prices. But in South Carolina, sales tax revenue also took a big hit over the past two fiscal years as the legislature reduced the sales tax on unprepared food from five percent first to three percent, and then to zero. The BEA estimated that this policy change reduced sales tax revenue by $169 million in 2007-08, including sales tax revenue to the General Fund, to the Education Improvement Act Fund, and to the Homestead Exemption Fund. The EIA Fund was held harmless from the food tax reduction in 2006-2007 and 2007-08, but there is no permanent guarantee on the books for future years.

The General Assembly also made a significant change to the individual income tax that took effect in 2007-08: the elimination of the lowest tax bracket (2.5 percent) for all taxpayers. The BEA estimated that the revenue impact of this tax cut was $86.4 million in 2007-08.

Excise Taxes: Alcoholic Beverages, Beer, Wine and Tobacco

Like most other states, South Carolina taxes alcoholic beverages, beer, wine, and tobacco products. Revenue from these taxes flows to the General Fund. The state also levies an excise tax on motor fuel (technically, a motor fuel user fee), but the revenue from that tax is earmarked for transportation expenditures. All these taxes suffer from the same problem. They are levied at a fixed amount per unit that has not been regularly increased to keep up with inflation. As a result, their importance in state revenue has declined substantially over time.

Long term revenue trends. In 2006-07, revenue from the taxes on alcoholic beverages, beer, and wine was almost $156 million, or 2.2 percent of recurring General Fund revenue. Twenty years earlier, however, these taxes contributed 4.3 percent of General Fund revenue. Revenue from the business license tax on tobacco contributed $31.7 million to the General Fund in 2006-07 (0.4 percent of the total compared to 1.1 percent in 1986-87). Unlike the taxes on alcohol, revenue from this tax is barely holding its own in current dollars as a result of long term declines in the number of smokers and programs that discourage young persons from starting to smoke. The erosion of these taxes by inflation can be clearly seen in Figures 16 through 19.

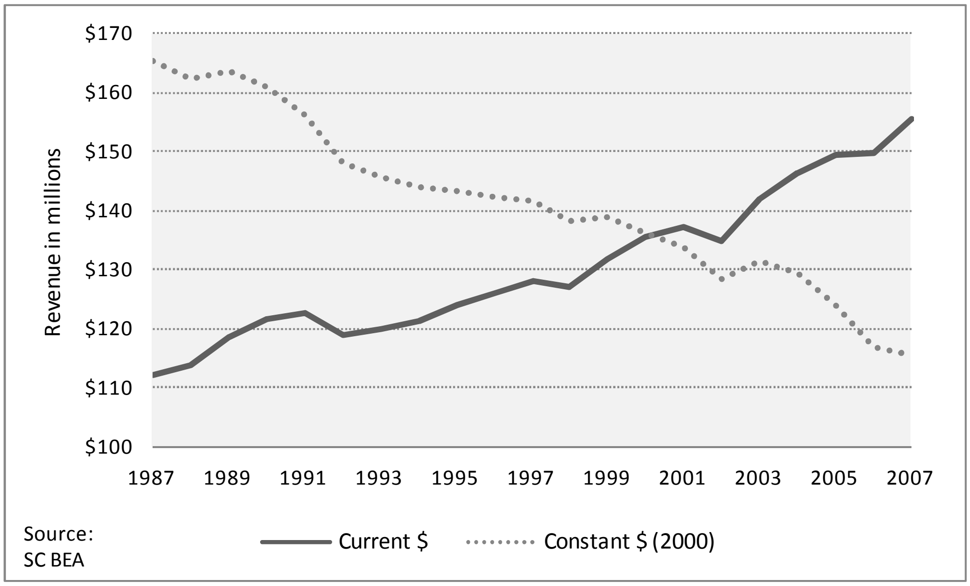

Figure 16. Revenue to the SC General Fund from taxes on alcoholic beverages, beer, and wine

Current revenue trends. Revenue growth in current dollars from the excise taxes on alcoholic beverages, beer, and wine was small but positive into 2007-08. Revenue from both taxes grew at one percent over the year, keeping up with population growth but not inflation. Revenue from the business license tax on tobacco declined almost 2 percent over the year, more than twice as fast as during the state fiscal crisis. Unless the tax rates on these products are raised, real per capita revenue is likely to remain a declining portion of the General Fund.

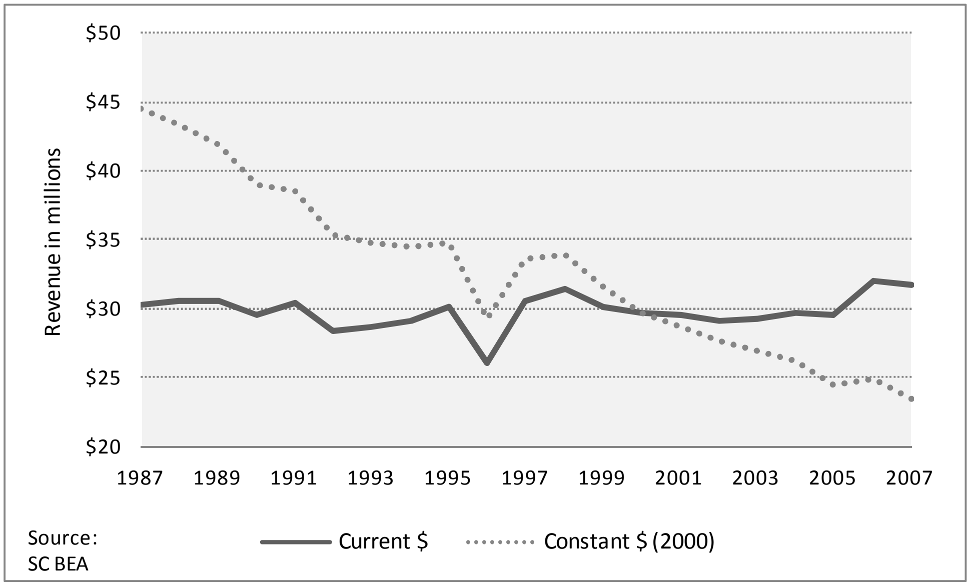

Figure 17. Revenue to the SC General Fund from the business license tax on tobacco

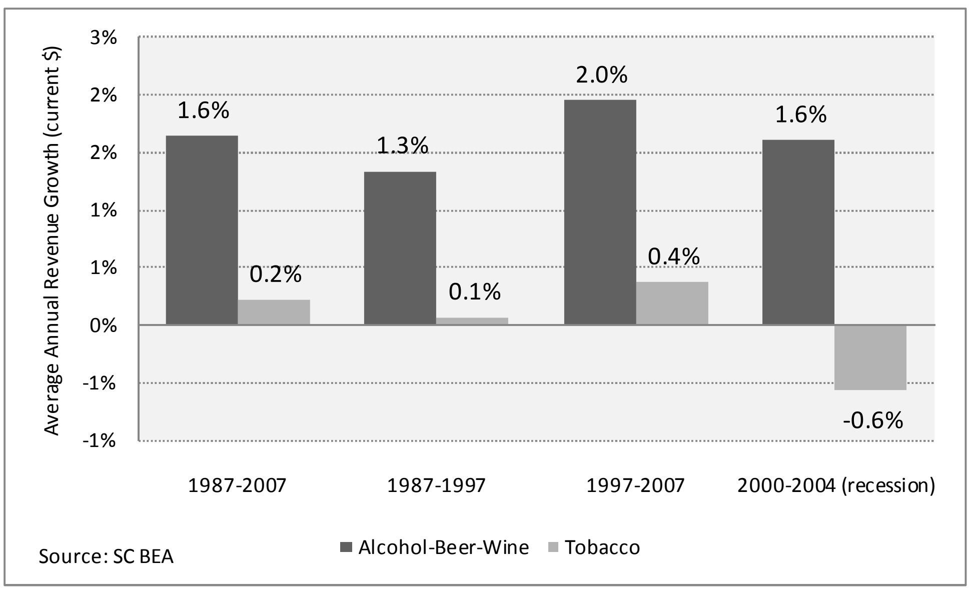

Figure 18. Average annual growth in alcoholic beverage, beer, wine, and tobacco tax revenue to the SC General Fund

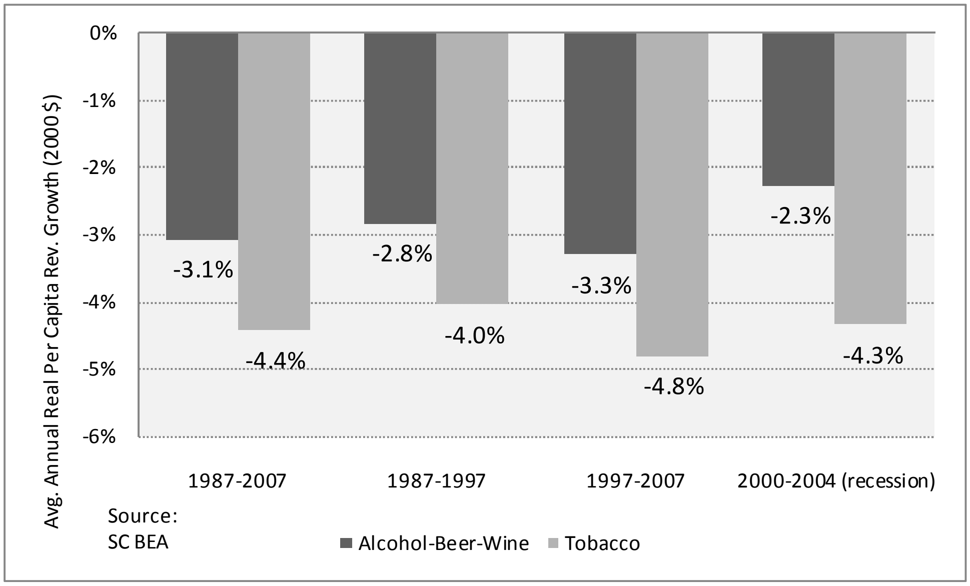

Figure 19. Average annual growth in real per capita alcoholic beverage, beer, wine, and tobacco tax revenue to the SC General Fund

Other General Fund Revenue

Other General Fund revenue sources include a variety of taxes on business income (including the bank tax, business license tax, and corporation license tax), additional excise taxes (admissions, bingo games, coin-operated devices, electric power, aircraft, and insurance premiums), and departmental fees and charges, among others.[9]

Over the 20 year period from 1986-87, other General Fund revenue grew at about half the rate of revenue from the sales and individual income taxes.

Long term revenue trends. Revenue from these assorted taxes and fees is somewhat responsive to economic trends and changes to the tax code. As a group, however, these revenues tend to change more slowly than the sales and income taxes in response to economic changes (Table 4, Figure 20). Over the 20 year period from 1986-87 to 2006-07, other General Fund revenue grew at about half the rate of revenue from the sales and individual income taxes.

Over time, revenue growth from this group of assorted taxes and fees has been adversely affected by elimination of certain taxes. Full phase out of the soft drink tax in 2001-02 eliminated close to $36 million in revenue from the General Fund, according to the BEA. The phase out of the federal estate tax, with its link to the state estate tax, has had a particularly large impact on General Fund revenue.

South Carolina's estate tax used to provide over eight percent of revenue from other sources (taxes on alcohol and tobacco products excluded), but along with phasing out the federal estate tax, federal legislation signed in June 2001 also phased out the state credit percentage. Instead of allowing a credit against federal estate taxes for 100 percent of state estate taxes paid, the new law phased the state credit out over 4 years, ending in 2005. The

[9] Revenue from the excise taxes on tobacco products and alcoholic beverages are excluded from these totals and are discussed separately in this report. General fund revenue reports from the BEA and Comptroller General usually include these taxes in this category, however.

credit had made state estate taxes painless to heirs, since the total tax liability was the same with or without a state estate tax. Eliminating the credit made it more difficult for states to rewrite their estate or inheritance tax laws so as to avoid revenue losses as a result of the new federal law.

Table 4. Average Annual Growth in Other General Fund Revenue (alcohol and tobacco excise taxes excluded)

Period	Revenue (current $)	Real Revenue Per Capita (constant $)
1986-87 to 2006-07	2.4%	-2.3%
1986-87 to1996-97	4.6%	0.3%
1996-97 to 2006-07	0.3%	-4.9%
1999-2000 to 2003-04 (state fiscal crisis)	-0.5%	-4.3%

Source: SC BEA.

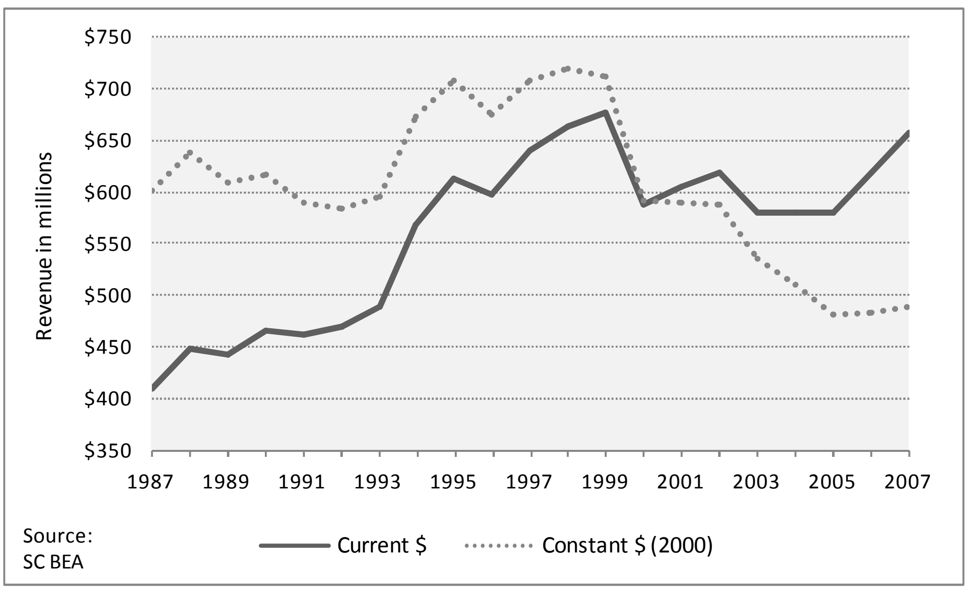

Figure 20. Other recurring General Fund revenue, 1987 to 2007

At the same time, the threshold for filing an estate tax return was raised gradually from $675,000 in 2001 to $3.5 million in 2009, with complete repeal in 2010. The top bracket rate also dropped from 60 percent to 45 percent. The steady increase in the threshold for paying an estate tax meant a significant loss of revenue to states with estate taxes, and the reduced credit made the state tax more burdensome to heirs.

Seventeen states and the District of Columbia have retained estate taxes by enacting estate or inheritance taxes that are similar to but separate from the federal estate tax. Thirteen of the seventeen "decoupled" their taxes from these federal changes in one way or another, most by tying their estate taxes to the federal estate tax as it existed prior to 2001. Others simply enacted estate taxes that were not in any way linked to the federal law with their own rates and thresholds. The estimated annual loss of revenue for all states by 2010 is $9 billion by 2010 when the federal estate tax is completely eliminated (McNichol, 2006; Michigan League for Human Services, 2007). For South Carolina, the BEA estimated that the annual revenue loss to the General Fund in 2006-07 was over $62 million.

Current revenue trends. This group of taxes and fees showed strong revenue growth of 6.5 percent in 2006-07, but this trend was reversed in 2007-08. Revenue dropped 7.6 percent, aided by relatively large declines in revenue from the bank and insurance taxes, the documentary stamp tax (which is linked to the declining real estate market), motor vehicle licenses, and the elimination of the electric power tax.

Revenue Outside the General Fund

The state of South Carolina's budget is much larger than the General Fund alone. The General Assembly's $20.8 billion appropriations bill for 2008-09 was based on anticipated revenue to state's General Fund ($6.7 billion, tax relief transfers excluded), state revenue from other sources that is earmarked or restricted for specific purposes ($7 billion), and federal funds ($7.1 billion). Revenue and spending that does not pass through the General Fund receives less scrutiny from the legislature and the public over time because annual budgets are less closely examined. Revenue outside the General Fund is not readily available for appropriations in special, or emergency, circumstances. Some earmarked and restricted state revenue is closely tied to the General Fund, however.

Retail sales tax. One-third of the state's retail sales tax revenue is earmarked outside the General Fund. The Education Improvement Act (EIA) Fund and the new Homestead Exemption Fund (HEF) are each funded with one penny of sales tax revenue. Revenue from these two cents of the sales tax behaves the same as the four cents that goes into the General Fund—revenue grows in good times and declines in bad times. And changes to the sales tax base also affect revenue collections, such as the elimination of the sales tax on groceries. Over the past two fiscal years, the legislature used general funds in the amount of $46.3 million to hold the EIA Fund harmless from eliminating the sales tax on food but this is not an ongoing legislative obligation. Unlike the HEF, which is legislatively protected from shortfalls with general funds, the EIA Fund and the educational programs it supports are adversely affected by downturns in sales tax revenue collections.

In the first year (2007-08), the Homestead Exemption Fund did not take in enough revenue to fully fund the legislative commitment to tax relief, so that $14.5 million of General Fund revenue had to be used to cover the obligation.

The HEF is used to fund expanded homeowner school property tax relief authorized by Act 388 of 2006. If the earmarked revenue is not sufficient the difference is made up out of the General Fund. In the first year (2007-08), the HEF did not take in enough revenue from the sixth penny on the state sales tax to fully fund the legislative commitment to property tax relief, so that $14.5 million of General Fund revenue had to be used to cover the obligation. The BEA estimates that $36.2 million will be required from the General Fund to meet this property tax relief obligation by the end of fiscal year 2008-09 because of the current decline in sales tax revenue. The BEA estimates the HEF shortfall at $70.3 million for 2009-10.

Revenue transfers from the General Fund. Over the past decade the General Assembly has moved other General Fund revenue (from the individual and corporate income taxes) to an off-budget fund for property tax relief, the Trust Fund for Tax Relief. In 1998-99, the first year in which this revenue was transferred out of the General Fund, state tax revenue was growing rapidly and legislators were accustomed to hefty year-end surpluses. In 2007-08, as revenue growth was slowing, over $520 million in revenue was removed from the General Fund to be used for homeowner and business property tax relief. In the current year, the BEA estimates this obligation to be higher at $531 million, even when total revenue is expected to be lower than in the previous year. The revenue transferred to the Trust Fund for Tax Relief is no longer available for General Fund appropriations without a change in the law. In an extended uncertain economic environment, however, it may be desirable to be able to use some of that revenue for other state purposes.

Moving income tax revenue off-budget for tax relief created a second problem. It lowered the base of the General Fund on which two important state funding obligations are calculated: the Local Government Fund (state aid to counties and municipalities) and the state's budgetary reserve funds. Over the past decade, the funding reduction for these two purposes has become noticeable, especially in the budgetary reserve funds at a time that the state is facing revenue shortfalls. Table 5 illustrates how much higher these three funds could have been in 2007-08 had the revenue used for the Trust Fund for Tax Relief remained in the General Fund.

Table 5. Formula Funding Affected by Moving General Revenue Off Budget

Example: 2006-07 property tax relief transfers = $515.4 million	Formula Pct. of GF	Difference in 2007-08 (millions)
Local Government Fund	4.5%	$23.2
General Reserve Fund	3%	$10.3
Capital Reserve Fund	2%	$15.5

Source:: SCBEA

GENERAL FUND EXPENDITURE TRENDS

Average growth of General Fund expenditures was consistently lower than average growth of General Fund revenue in South Carolina for the entire twenty year period over fiscal years 1986-87 to 2006-07. Spending kept pace with revenue growth during the first ten years, 1987 to 1997, but not in the last ten years. Tax cuts plus the last recession took a toll on inflation-adjusted per capita revenue and spending in the last ten years. While both declined, spending fell significantly more than revenue, as Table 6 indicates.

Average growth of expenditures was consistently lower than average growth of revenue in South Carolina for the entire twenty year period.

Table 6. Average Annual Growth in Total General Fund Expenditures

Fiscal Year	Spending (current $)	Real Spending Per Capita (constant $)
1986-87 to 2006-07	4.3%	-0.5%
1986-87-1996-97	5.4%	1.1%
1996-97 to 2006-07	3.2%	-2.1%
1999-2000 to 2003-04 (state fiscal crisis)	-1.0%	-5.3%

Source: SC BCB, Office of State Budget

Education services are the largest overall category of spending in the South Carolina General Fund at almost 51 percent of the total in 2006-07. Spending on elementary and secondary education is the larger share at over one-third of total spending using general funds (Figure 21, Table 7). State spending on health and social rehabilitation, much of it Medicaid-related, is the second largest spending area, at nearly a quarter of the total. Corrections is the next largest category at seven percent of the total.

South Carolina earmarks certain revenue for particular purposes before it even gets to the General Fund. Earmarking protects those spending categories, but it also makes the remaining programs and services more vulnerable to economic downturns when revenue falls and spending must be cut. For example, aid to subdivisions (local governments) and debt service on general obligation bonds only receive appropriations from the General Fund. Transportation, health, and higher education rely much more heavily on non-general funds, such as earmarked or restricted state revenue (motor fuel user fee), federal funds (for roads and Medicaid) and tuition (higher education). However, because they have other revenue sources, they often suffer larger cuts when the budget is underfunded.

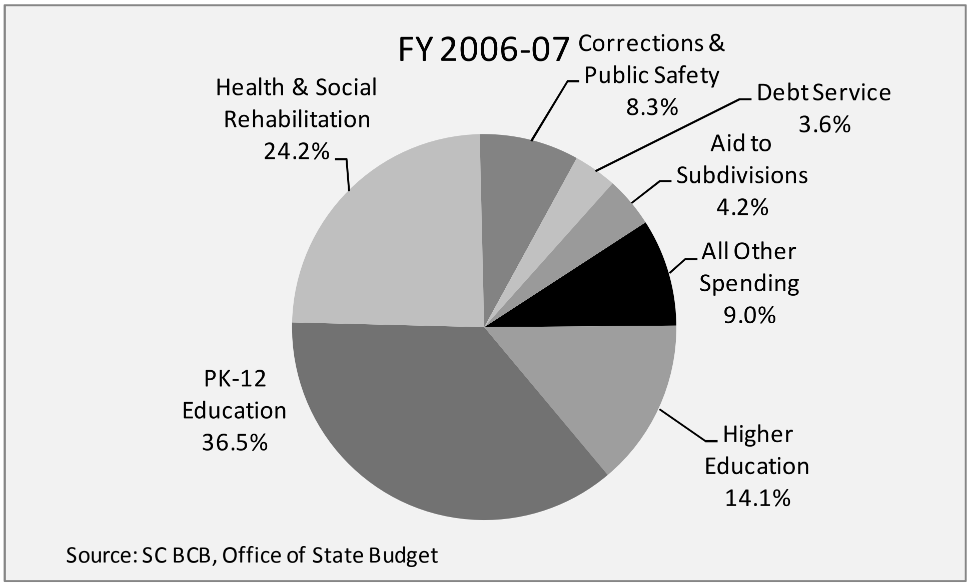

Figure 21. South Carolina General Fund spending, 2007

Table 7. South Carolina General Fund Expenditures, 2006-07

Category	Expenditures (millions)	Spending Per Capita	GF Spending Share	General Funds as Share of Total Funds
PK-12 Education	$2,271.4	$515	36.5%	54.6%
Health & Social Rehabilitation	1,509.3	342	24.2%	20.5%
Higher Education	876.6	199	14.1%	24.1%
Corrections	438.4	99	7.0%	75.7%
Executive & Administrative	269.5	61	4.3%	39.6%
Aid to Subdivisions	264.2	60	4.2%	100.0%
Debt Service	226.8	51	3.6%	100.0%
Conservation, Natural Resources & Economic Development	166.7	38	2.7%	34.7%
Public Safety	79.9	18	1.3%	57.7%
Regulatory	55.5	13	0.9%	19.7%
Judicial	38.6	9	0.6%	65.1%
Legislative	30.9	7	0.5%	90.8%
Transportation	1.1	0	0.0%	0.1%
Total	$6,229.1	$1,413	100.00%	32.6%

Source: SC BCB, Office of State Budget

Spending on all major state government functions except health and social rehabilitation (mostly Medicaid) declined from 1987 to 2007 after adjusting for population growth and inflation.

Tables 8 and 9 show great differences in spending growth across categories. Health and social rehabilitation was the only major spending category to see inflation-adjusted per capita growth over the last decade, and corrections and public safety was the only additional category to see such growth over the entire 20 years, although most of it was in the earlier decade. All of the remaining major spending categories declined from fiscal years 1986-87 to 2006-07 after adjusting for population growth and inflation. Corrections and public safety spending declined 10.3 percent in real dollars per capita during the state fiscal crisis. Higher education saw a 1.9 percent decline in current dollar spending and a 6.1 percent decline in inflation-adjusted per capita spending during the state fiscal crisis. PK-12 education also took a substantial reduction in both current dollars and inflation-adjusted dollars per capita. Aid to subdivisions includes the mandatory 4.5 percent of General Fund revenue based on the last completed fiscal year that is distributed to counties and municipalities. This category declined sharply over the recent decade. Debt service growth (or decline) simply reflects the amount of bonds issued and outstanding and current interest rates, which were lower in the most recent decade than the preceding one.

Table 8. Average Annual General Fund Spending Growth in Current Dollars

Period	Higher Education	PK-12 Education	Health & Soc. Rehab.	Public Safety & Correct.	Debt Service	Aid to Subdivs.*	All Other	Total
1986-87 to 2006-07	3.1%	4.3%	6.0%	6.1%	3.8%	2.1%	2.9%	4.3%
1986-87 to 1996-97	3.5%	4.0%	6.4%	11.8%	3.9%	11.3%	2.4%	5.4%
1996-97 to 2006-07	2.8%	4.6%	5.6%	0.8%	3.8%	-6.3%	3.4%	3.2%
1999-2000 to 2003-04	-1.9%	-0.3%	-0.2%	-6.2%	12.9%	4.9%	-6.3%	-1.0%

Source: SC BCB, Office of State Budget. *1999-2000 to 2003-04 growth is overstated due to the inclusion of deferred expenditures in the first year.

Table 9. Average Annual General Fund Spending Growth in Per Capita Constant Dollars

Period	Higher Education	PK-12 Education	Health & Soc. Rehab.	Public Safety & Correct.	Debt Service	Aid to Subdivs.*	All Other	Total
1986-87 to 2006-07	-1.6%	-0.5%	1.1%	1.2%	-1.0%	-2.6%	-1.9%	-0.5%
1986-87 to 1996-97	-0.7%	-0.2%	2.1%	7.2%	-0.4%	6.7%	-1.8%	1.1%
1996-97 to 2006-07	-2.5%	-0.8%	0.2%	-4.4%	-1.6%	-11.2%	-1.9%	-2.1%
1999-2000 to 2003-04	-6.1%	-4.6%	-4.5%	-10.3%	8.0%	0.3%	-10.4%	-5.3%

Source: SC BCB, Office of State Budget. *1999-2000 to 2003-04 growth is overstated due to the inclusion of deferred expenditures in the first year.

PROJECTIONS FOR SOUTH CAROLINA GENERAL FUND REVENUE AND SPENDING 2009-2013

Projections of South Carolina's General Fund revenues and expenditures can provide useful information for legislators, citizens, and state agencies, particularly in creating and maintaining a system of revenue and spending that can be sustained over the ups and downs of the economy. The key to a state's fiscal sustainability is the long-term balance between revenue and spending. If one grows faster than the other, legislators face a policy challenge to bring them back into balance, as they have already had to do in the current fiscal year.

Since 1997, each fiscal sustainability report we have completed includes projections of future General Fund revenues and expenditures. These projections are not intended to compete with the more detailed and timely revenue estimates made by the South Carolina Board of Economic Advisors and used during the annual budget appropriations process. Rather, they are prepared to describe overall revenue and expenditure trends in the state based on the current state revenue structure and conservative assumptions about future spending. Projections are based on expectations about the future state and national economies, historical revenue and appropriations patterns, and estimated future South Carolina population growth rates.

Table 10 shows three sets of South Carolina General Fund revenue and expenditure projections for fiscal years 2010-11 through 2012-13. Revenue for fiscal year 2008-09 and 2009-10 are from the BEA's November 2008 official estimate. All future revenue projections are based on the BEA's 2009-10 estimate. All spending projections are based on a single estimate for 2008-09. This estimate is from appropriations act spending category totals, which were reduced by $488 million by the General Assembly in October 2008. General Fund spending in 2009-10 was kept at the current year's level, based on the BEA's expectation of no revenue growth in 2009-10.

The low revenue projection is a simple projection of estimated 2009-10 total General Fund revenue at its 1997 to 2007 growth rate of 4.5 percent a year in current dollars. The middle and high projections use different assumptions about how responsive the retail sales tax and the individual income tax are likely to be to state personal income growth. The middle projection uses the BEA's assumptions, which have sales tax revenue growing almost as fast as state personal income, and the individual income tax revenue growing about 10 percent faster than personal income. The high projection uses different assumptions, which have sales tax revenue growing only 77 percent as fast as personal income, and individual income tax revenue growing much faster than personal income (Bruce, Fox, and Tuttle, 2006). Selected other large revenue categories are treated identically in the middle and high projections—they are projected at their long term annual growth rate starting in 2010-11. State personal income is assumed to gradually increase from zero growth in 2009-2010 to the long term trend of 5.4 percent a year by 2012-13.

The low projection on the spending side is made by projecting major spending categories at their average growth rates from 1997 to 2007. The middle spending projection differentiates between different spending categories. Some are projected at their historical growth rate (the state's administrative, executive, and legislative functions, for example), while others are projected at a combination of inflation with anticipated client (population) growth (higher education, PK-12 education, corrections). Recognizing that state spending is at a low point in recent years by any measure, the high projection increases spending in each category starting in 2010-11 to bring it back to its higher real per capita level of 2007-08.

Combining these sets of revenues and expenditures yields four sets of projections of General Fund budget surplus or shortfall for fiscal years 2008-09 through 2012-13 (Table 11).

Table 10. South Carolina General Fund Revenue Projections through 2012-13

	2008-09 ($ millions)	2009-10 ($ millions)	2010-11 ($ millions)	2011-12 ($ millions)	2012-13 ($ millions)
Revenue*					
High	6,026.2	6,012.0	6,347.0	6,719.4	7,134.0
Medium	6,026.2	6,012.0	6,298.5	6,612.5	6,957.0
Low	6,026.2	6,012.0	6,296.2	6,593.5	6,904.3
Expenditure**					
High	6,248.2	6,248.2	7,024.5	7,904.8	8,904.9
Medium	6,248.2	6,248.2	6,552.6	6,875.6	7,216.1
Low	6,248.2	6,248.2	6,480.7	6,725.5	6,982.9

Note: Revenue transferred to Trust Fund for Tax Relief excluded

*2008-09 and 2009-10 revenue based on November 7, 2008 SC BEA estimate. **2008-09 spending is appropriations after October 2008 reduction of $487 million.

Table 11. South Carolina General Fund Surplus or Shortfall Projections through 2012-13

	2008-09 ($ millions)	2009-10 ($ millions)	2010-11 ($ millions)	2011-12 ($ millions)	2012-13 ($ millions)
High Rev. – High Exp.	-222.0	-236.1	-677.5	-1,185.4	-1,770.9
High Rev. – Low Exp.	-222.0	-236.1	-133.7	-6.1	151.1
Low Rev – High Exp.	-222.0	-236.1	-728.3	-1,311.4	-2,000.6
Low Rev – Low Exp.	-222.0	-236.1	-184.5	-132.0	-78.6

Even in the most optimistic scenario—high revenue growth, low spending growth—there are deficits every year until a modest surplus of $151 million in 2012-13. Every other scenario shows deficits that range from $6 million in 2011-12 in the best case scenario to $2.0 billion with the low revenue and high spending projections. To make matters worse, the new baseline for spending is a level of per capita spending that is already substantially below not just the levels of the late 1990s, when economic conditions were most favorable, but even as far back as 1987, after adjusting for inflation and population. In 2008-09, General Fund appropriations (adjusted for the BEA's lower revenue expectations) are $312 less per capita in inflation-adjusted terms than they averaged over the 17 year period from 1986-97 to 2002-03. Tax cuts and cycles of boom and bust have made it very difficult to sustain adequate state services, let alone make any improvements. A continued weak economy, or any effort to restore services—to improve the highway system, invest in public education, restore some level of support for higher education, reduce prison overcrowding—will make projected deficits even larger.

ISSUES TO BE ADDRESSED IN THE NEXT FEW YEARS

South Carolina, and other states, will be facing serious challenges to budgeting and service delivery in the coming months and years. With the impact of federal and international intervention in failing financial institutions and credit markets to be determined, the economy is likely to be unstable for some time. But even in the middle of these current challenges, however, we encourage legislators to keep an eye on the horizon and not forget how state budget decisions affect the fiscal sustainability of the state's revenue system.

Several significant changes in South Carolina's tax structure and expenditure commitments have taken place since our last report on fiscal sustainability. They have had the effect of reducing the state's fiscal sustainability.

Revenue Issues: Tax Structure

The most significant changes affecting revenue were changes in the individual income tax and an increase in the state retail sales tax. Taken together, these two taxes provide over well over 80 percent of state General Fund revenue.

Retail Sales Tax and Property Tax Relief. In 2006, Act 388 increased the state retail sales tax rate from 5 percent to 6 percent and dedicated all the revenue to funding relief from all school operations property taxes for owner-occupied residential property. After the first year, the replacement funds will not be related to the amount of owner-occupied property, but will just grow at the same rate as population plus inflation. Distribution of increased funds will be based on the district's share of weighted pupil units. The revenue from the extra penny, which brought in $550.5 million in 2007-08, is diverted to an off-budget fund, the Homestead Exemption Fund, for that purpose.

If the additional sales tax revenue is not sufficient to fund the guaranteed amount of property tax relief, the state has committed to provide additional funds out of the General Fund. If the additional sales tax revenue exceeds the amount needed, the surplus funds are applied to relief from city and county property taxes for homeowners. Thus, the higher rate for the retail sales tax does not generate any additional General Fund revenue, but the accompanying property tax relief program does create a potential future spending obligation for the General Fund. This obligation was realized in the first year of implementation, when $14.5 million in additional funds from the General Fund were required.

Second year (2008-09) disbursements to school districts, which are calculated on a formula basis, will be $586.1 million, or over $20 million more than the amount needed for the past year, according to the BEA. In an economy where the outlook for retail sales is poor for the coming year, the state's new homeowner school property tax relief program may require a higher level of support from the General Fund than policy makers intended. The BEA's November 2008 revenue estimate puts the HEF shortfall at $36.2 million in 2008-09 and at $70.3 million in 2009-10.

Retail Sales Tax on Unprepared Food. Beginning in October 2006, the sales tax on unprepared food was reduced to 3 percent and subsequently eliminated in November 2007. The exemption of food from the sales tax affects not only EIA Fund revenue, HEF (property tax relief) revenue, and local option sales tax revenue, but also the General Fund, which receives revenue from the first 4 percent of the 6 percent state sales tax. Table 12 shows the estimated revenue loss from this change. It should be noted that exempting food not only reduces revenue but also makes sales tax revenue less stable, because food is one of the most stable expenditures by households during recessions and expansions alike.

Table 12. Estimated General Fund Revenue Impact of Reduction in Sales Tax on Food

Tax Reductions	2006-07 ($ millions)	2007-08 ($ millions)	2008-09 ($ millions)
5% to 3%	96.5 (9 months)	33.7	135.0
3% to 0%	--	135.0 (8 months)	202.5
Total	96.5	168.7	337.5

Source: SC BEA and author's calculations

Individual Income Tax. The bottom 2.5 percent bracket for the individual income tax was eliminated in 2007-08 at an estimated first-year revenue loss of $86.4 million. Unincorporated business firms, which file individual income tax returns, were permitted to use the same flat 5 percent rate as incorporated business firms rather than the progressive 4 percent to 7 percent rate schedule facing individuals. Phased in over a three year period starting in 2005, this change resulted in an estimated revenue loss of $54.5 million in the first full year, 2007-08.

Homestead Exemption. The homestead property tax relief for elderly and disabled homeowners (city, county and school taxes) was increased in 2000. The state now reimburses local governments for property tax relief on the first $50,000 instead of the first $20,000 prior to 2000. The necessary funds are diverted from the General Fund into the Homestead Exemption Fund, which also holds the revenue for property tax relief for homeowners. This tax relief program was estimated to require at least $174 million in 2007-08. It has grown at or above the rate of population plus inflation in six of the past seven years, and as the population ages, the demand for this entitlement will continue to grow. This property tax exemption is not linked to income or ability to pay.

These changes in the South Carolina state tax structure made in the last few years will have a large impact on revenue for years to come. In 2007-08, the General Fund would have ended the year with about $324 million in additional revenue had the sales and income tax changes not been implemented.

Revenue Issues: Adequacy and Stability

The legislature has responded to criticism of past budgetary practices by cutting back on the practice of annualization of expenditures that are initially funded out of surplus revenues. Annualization means committing those nonrecurring funds to recurring expenditures that must be financed in future budgets. However, that commitment has not extended to tax cuts. Most tax cuts take the same form as an annualization, a loss of revenue not only to the current budget but to future budgets as well. Legislators need to be more attentive to the long run budgetary impact of tax cuts in terms of sustainability.

The overall tax structure should be reviewed with stability in mind in addition to the usual concerns about adequacy and equity.

As examined earlier in this report, state tax revenue—especially sales and individual income tax revenue—is very sensitive to fluctuations in economic activity. Some of the minor revenue sources, chiefly excise taxes, are more stable over the ups and downs of economic activity, while others such as the corporate income tax are even more unstable.

The overall tax structure should be reviewed with stability in mind in addition to the usual concerns about adequacy and equity. The revenue stream can be made more stable and more adequate by broadening the base, i.e., having fewer exemptions from the sales tax and fewer adjustments, deductions and credits on the income tax. The use of surplus funds in good years can also contribute to stability by using some of these funds for nonrecurring expenditures and others for strengthening reserve funds.

Revenue Issues: Reserve Funds

Despite the lessons of the recent state fiscal crisis, the General Assembly has not yet acted to strengthen the budgetary reserve funds needed to maintain services when there is a revenue shortfall. The Government Finance Officers Association, a national organization of state and local government finance professionals, recommends that reserve funds hold a minimum of 10 percent of the previous year's adopted budget, South Carolina's two reserve funds together are only half that level: General Reserve Fund (3 percent) and Capital Reserve Fund (2 percent).

Expenditure Issues: Spending Caps

Thirty one states have some kind of tax and/or spending limitations (TELs). Most of them were adopted in the late 1970s or early 1990s (Bae and Gais, 2007). They take a variety of forms, but some limit on the growth of spending is a fairly common type of TEL. Spending caps are related to both the revenue and expenditure sides of the budget, because they are often used to keep legislators from spending all the additional revenue when revenue is rising more rapidly than some economic indicator or blend of indicators, such as inflation, population growth, and/or state personal income.

At present, the state has a relatively nonbinding growth constraint that limits the growth rate of spending to either the average rate of growth in state personal income or 9.5 percent of state personal income, whichever is greater. Personal income reflects not only population growth and inflation but also increased affluence that requires or demands more public services to meet the needs of households and business firms. This constraint was adopted in 1980-81 in the national wave of tax and expenditure limitations. South Carolina has only exceeded the spending limit in the first year and had $3.6 billion in excess spending capacity in 2007-08.

In the 2008 legislative session, the General Assembly gave serious consideration to a proposal to tighten the spending caps on both state and local governments and specifically limit the growth of spending to the rate of growth of population plus the consumer price index. This very stringent requirement would create significant problems in implementation. In part, the demand for caps was a reaction to the revenue bonanza that was projected to provide more than $1 billion in "new money" for the General Fund in 2007-08.

Colorado, which has one of the most stringent limitations on spending growth in the nation (TABOR, an acronym for Taxpayers Bill of Rights), was forced to modify its spending cap in 2006. Like the proposal in the South Carolina General Assembly, TABOR limited growth of state spending to population growth plus inflation (ibid.).

Expenditure Issues: Education

The commitment to offer access to higher education for all South Carolina high school graduates is eroding at a rapid pace even as the state's economic development requires an increasingly educated work force. The state share of General Fund appropriations for higher education decreased from 17.2 percent of the total in 1986-87 to 12.9 percent in 2006-07. Lottery-funded scholarships averaging $175 million per year over the last four years have filled some of the gap, but students who fail to qualify initially or to maintain their required B average face very large tuition bills.

Higher education has seen some of the largest declines in real per capita spending among major state General Fund budget categories. State General Fund expenditures on higher education (lottery funds excluded) declined 1.9 percent a year in real per capita terms between 1986-87 and 2006-07. Real per capita spending on higher education in South Carolina declined 10.4 percent a year during the state fiscal crisis of 2000 to 2004. The result of declining state funding for higher education is that tuition at South Carolina's public institutions has increased.

The commitment to offer access to higher education for all South Carolina high school graduates is eroding at a rapid pace even as the state's economic development requires an increasingly educated work force.

At the elementary and secondary level, South Carolina was one of 37 states to cut state aid per pupil between 2002 and 2005. The reduction of $874 per pupil (adjusted for inflation) was the fourth highest in the nation, exceeded only by Michigan, Oregon and New Hampshire (Bae and Gais, 2007b). The average state reduced per pupil spending by $321 over that period.

At present, the General Assembly is under increasing pressure to make education funding more adequate, more equitable, and less complex. Act 388 of 2006 significantly altered the distribution of state funds among districts, favoring both very small districts with the minimum $2.5 million distributions per county of homeowner property tax relief, and districts with a high proportion of high-valued owner-occupied residential property in their tax bases. Reforms are under consideration with proposed plans generated by task forces in the State Department of Education. Most proposals under consideration protect districts with more revenue per pupil from losing state aid, so a leveling up approach will require additional funding. The most recent decision in the long-running court case on school funding also called for additional expenditures for early childhood education.

Both of these education issues, combined with the strong perceived link between both public and higher education and economic development in the business community, will create upward pressure on education spending at all levels. Other states are under similar pressures to improve education funding, so South Carolina may be forced to respond simply to not fall behind in the competition for educational quality as a factor in business and household location decisions and as an economic development concern.

Expenditure Issues: Medicaid

As indicated earlier, growth in the cost of medical care has been and will continue to be a major driver of state spending demands nationally and in South Carolina. The amount of federal assistance a state receives for Medicaid is determined by a match rate that ranges from 50 percent to 75.84 percent of state spending, with higher match rates for states with lower per capita incomes. South Carolina's matching rate for FY 2008-09 is 70.07 percent, meaning that the state receives seventy cents in federal match for every dollar spent by the state (Kaiser Family Foundation, 2008). The reverse is that every dollar reduction in Medicaid spending results in a loss of three dollars in federal aid. This threatened loss of federal aid puts pressure on states to avoid cutting Medicaid even in tight budget years. Tight budget years usually correspond to recessions (with a lag), and recessions compound the challenge because the number of eligible individuals rises with increased unemployment. The state percentages are recomputed each year based on the average of three years' personal income, which means that there is a lag that is particularly important during economic downturns.

The retirement of the baby boom generation is expected to increase the demands for long term care, which currently accounts for about one-third of Medicaid spending. The Medicaid program (as well as the State Children's Health Insurance Program, SCHIP) is currently in a state of flux in terms of future funding and federal aid. The issues of state fiscal volatility, of the relative shares of federal and state obligation, and its role in covering the uninsured and in providing long-term health care for the elderly are all likely to be reviewed and revised after the 2008 elections, regardless of the specific outcome.

SCHIP covers uninsured low-income children up to some income limit, most commonly 200 percent of the poverty level, although some states go up to 300 percent. Federal assistance for these state programs was scheduled in the budget baseline to drop from $6.6 billion in 2007-08 to $5 billion in 2010 and thereafter. This level of funding would not be sufficient to cover all eligible children based on family income and insured status. However, the December 2007 reauthorization provided an additional $1.6 billion in 2007-08 and $275 million for 2008-09 above the $5 billion baseline. South Carolina is one of 14 states that does not have a separate SCHIP program, although many children are covered under Medicaid (Park, 2008).

Health care costs for state employees, state retirees, and Medicaid continue to grow at rates exceeding the growth of overall state spending, inflation and population, personal income, or any other indicator of potential revenue to fund the rising cost. As the population continues to age, Medicaid in particular has become a serious concern for many states, but particularly states like South Carolina that are popular retirement destinations.

CONCLUSION

Just a few short years ago, state revenues and budgets were recovering well from the state fiscal crisis associated with the 2001 recession. However, as Brinner and Brinner (2007) note, states have not appeared to understand these patterns [of economic fluctuations] and thus have—at least in the aggregate—left themselves in a more vulnerable than necessary position today. Specifically, at the recent revenue peak of fiscal year 2006-07, states are still just barely getting back to balance and many states are already spending from rather than bolstering their rainy day funds. The surpluses that should have materialized at that stage of the business cycle were small and brief compared to the shortfalls during the preceding recession, with more of the blame on the side of rising spending than a failure on the tax side of the equation. Brinner and Brinner also note that wage increases in the public sector have been at faster rates than in the private sector, contributing to future spending pressures.

South Carolina is on a parallel track with national trends in many respects; the current revenue shortfall and longer term revenue instability, the negative budgetary impact of past tax cuts, the rising spending pressures for education and health care, and the inadequacy of reserve funds. Some of these national pressures are exacerbated in a retirement-destination state that is experiencing increasing Medicaid (long-term care) demands while offering exceptionally generous property tax and income tax relief for the elderly. In addition, increased earmarks of new or additional tax revenues to off-budget funds have limited the growth of South Carolina's General Fund revenue and reduced budgetary flexibility during economic downturns.

The most important steps that South Carolina can take to stabilize and strengthen its budget resources are an enhanced General Reserve Fund, resistance to further earmarking, and diversifying General Fund revenue sources so that the state is not quite as dependent on sales and individual income tax revenues. Opportunities to strengthen revenue through indexing excise taxes and/or reinstituting the estate tax have not been given serious consideration, but both would offer additional revenue as well as revenue diversification. Eliminating some exemptions to the sales tax and adding taxation of services could broaden the tax base as well and offset some of the revenue loss from removal of the tax on unprepared food. Committing some surplus funds in good years to reserve funds instead of to additional spending or further tax cuts that have to be funded in deficit years as well would be a significant step in the direction of fiscal sustainability.

South Carolina's revenue and expenditure system is an integrated one. There are many ties between state and local revenue and spending through aid to subdivisions and funding for public education. But perhaps the most important tie is the state's regulation of the property tax, including millage caps and assessment caps as well as property tax relief. The property tax continues to be a major local revenue source. As the state places more restrictions on the property tax, local governments will become more dependent on the state for revenue for basic local services. The state's commitment to additional school property tax relief through Act 388 of 2006 represents a significant encumbrance on future general revenue.

South Carolina provides many important and valuable programs and services for citizens. We depend on the state for public education, higher education, public safety, highways, state parks and recreation, large parts of health care, and other services. Often those services are needed even more during periods of economic downturn, so it is important that the state be a source of stability rather than an addition to volatility in the economic lives of its citizens. A stable revenue system and an adequate reserve system, as well as a commitment by the legislature to caution in good economic times and protection for basic services in bad economic times, are the foundations of a stable and sustainable public budget that is the foundation for those services. The state is facing many important challenges and difficult issues in the years ahead. Most of them, directly or indirectly, involve the budget. Fiscal sustainability should have a top priority on the public agenda in the next few years to ensure that our state's economy, public and private, is built on a rock of fiscal sustainability and not the shifting sands of volatile revenue and emergency spending actions.

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